

New Jersey Division of Local Government Services  
**Application For Approval to Provide Financial Surety Bonds**  
**Proposal Submission Cover Sheet**

**I. Contact information**

Name of Organization: FSA

Contact person: Michelle MacKinnon and Sheilah McGuckin

Address: 350 Park Avenue NY NY, 10022

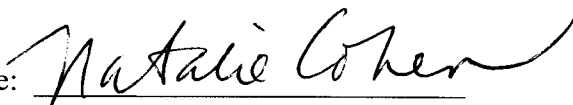
Phone: Voice: 212-339-3423

Fax: 212-399-3488

E-mail: surebid@fsa.com

Certification: I, Natalie Cohen hereby certify that I am authorized by the organization submitted this proposal to submit this application:

Name: Natalie Cohen

Signature: 

Title: Managing Director

Date: 02/24/2004

Include a file version of this form as part of the submission, and provide a printed copy with signature.

File the application via e-mail to: Mpfeiffer@dca.state.nj.us. Fax submissions to 609-292-9073. Submit any paper submissions to Marc Pfeiffer, Deputy Director, Division of Local Government Services, PO Box 803, Trenton, NJ 08625. Delivery address is 101 South Broad Street, Trenton, NJ. 08625.

**II. Application Contents:**

List the documents that are submitted in support of the application. Provide file names as appropriate.

- A. Certificate of proof that FSA is authorized to transact business in NJ
- B. Most recent financial statement of FSA
- C. Sure-Bid procedure
- D. The experience of Sure-Bid
- E. Other information; sample financial surety bond.



State of New Jersey  
DEPARTMENT OF BANKING AND INSURANCE

CERTIFICATE OF AUTHORITY

DATE: APRIL 16, 2003

NAIC COMPANY CODE: 18287

THIS IS TO CERTIFY THAT THE **FINANCIAL SECURITY ASSURANCE INC OF NEW YORK, NEW YORK**, HAVING COMPLIED WITH THE LAWS OF THE STATE OF NEW JERSEY, AND ANY SUPPLEMENTS OR AMENDMENTS THERETO WITH RESPECT TO THE TRANSACTION OF THE BUSINESS OF INSURANCE, IS LICENSED TO TRANSACT IN THIS STATE UNTIL THE FIRST DAY OF **MAY, 2004**, THE LINES OF INSURANCE SPECIFICALLY DESIGNATED BY THE FOLLOWING NUMERALS: **13 AND 27.**

PROPERTY/CASUALTY COMPANY  
N.J.S.A. 17:17-1

1. Fire & Allied Lines
2. Earthquake
3. Growing Crops
4. Ocean Marine
5. Inland Marine
6. Workers' Compensation & Employers' Liability
7. Automobile Liability (BI)
8. Automobile Liability (PD)
9. Automobile Physical Damage
10. Aircraft Physical Damage
11. Other Liability
12. Boiler & Machinery
13. Fidelity & Surety
14. Credit
15. Burglary & Theft
16. Glass
17. Sprinkler Leakage & Water Damage
18. Livestock
19. Smoke or Smudge
20. Physical Loss to Buildings
21. Radioactive Contamination
22. Mechanical Breakdown/Power Failure
23. Other (see reverse side)

N.J.S.A. 17B:17-4

26. Accident and Health

N.J.S.A. 17:17-1(g) and  
N.J.A.C. 11:7-1.1 et seq.

27. Municipal Bond Insurance

LIFE INSURANCE COMPANY  
Title 17B

28. Life
29. Health
30. Annuities
31. Variable Contracts
32. Other (see reverse side)

OTHER COMPANIES  
N.J.S.A. 17:46B-1 et seq.

33. Title Insurance  
N.J.S.A. 17:44A-1 et seq.
34. Fraternal Benefit Society  
N.J.S.A. 17:46A-1 et seq.
35. Residential Mortgage Guaranty Insurance
36. Commercial Mortgage Guaranty Insurance

SPECIAL CONDITIONS

40. Non-participating Insurance Only
50. Reciprocal Exchange
60. Reinsurance Only
70. Participating Business Requirements
80. Capital & Surplus Guarantee (see reverse side)
99. (see reverse side)

HOLLY C. BAKKE

COMMISSIONER



**FINANCIAL SECURITY ASSURANCE INC. AND SUBSIDIARIES**  
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The New York State Insurance Department recognizes only statutory accounting practices for determining and reporting the financial condition and results of operations of an insurance company, for determining its solvency under the New York Insurance Law, and for determining whether its financial condition warrants the payment of a dividend to its stockholders. No consideration is given by the New York State Insurance Department to financial statements prepared in accordance with accounting principles generally accepted in the United States of America in making such determinations.

## **REPORT OF INDEPENDENT ACCOUNTANTS**

To the Shareholder and Board of Directors  
of Financial Security Assurance Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations and comprehensive income, changes in shareholder's equity, and cash flows present fairly, in all material respects, the financial position of Financial Security Assurance Inc. and Subsidiaries (the Company) at December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PRICEWATERHOUSECOOPERS LLP

PricewaterhouseCoopers LLP  
New York, New York  
February 6, 2003

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**  
(Dollars in thousands, except per share data)

	<u>December 31, 2002</u>	<u>December 31, 2001</u>
<b>ASSETS</b>		
Bonds at market value (amortized cost of \$2,597,599 and \$2,211,247) . . . . .	\$2,811,747	\$2,303,431
Equity investments at market value (cost of \$10,000) . . . . .		10,070
Short-term investments . . . . .	<u>364,565</u>	<u>213,212</u>
Total investments . . . . .	3,176,312	2,526,713
Cash . . . . .	27,560	5,882
Deferred acquisition costs . . . . .	253,777	240,492
Prepaid reinsurance premiums . . . . .	557,659	420,798
Reinsurance recoverable on unpaid losses . . . . .	75,950	28,880
Securitized loans at cost . . . . .	431,718	
Investment in unconsolidated affiliate . . . . .	52,206	49,726
Other assets . . . . .	<u>206,458</u>	<u>165,788</u>
<b>TOTAL ASSETS . . . . .</b>	<u><b>\$4,781,640</b></u>	<u><b>\$3,438,279</b></u>
<b>LIABILITIES AND MINORITY INTEREST AND SHAREHOLDER'S EQUITY</b>		
Deferred premium revenue . . . . .	\$1,450,211	\$1,090,332
Losses and loss adjustment expenses . . . . .	223,618	114,428
Deferred federal income taxes . . . . .	153,333	133,877
Ceded reinsurance balances payable . . . . .	79,870	34,961
Notes payable to affiliate . . . . .	431,360	
Payable for securities purchased . . . . .	2,481	28,214
Long-term debt . . . . .	212,850	144,000
Minority interest . . . . .	52,841	46,157
Accrued expenses and other liabilities . . . . .	<u>203,751</u>	<u>147,638</u>
<b>TOTAL LIABILITIES AND MINORITY INTEREST . . . . .</b>	<u><b>2,810,315</b></u>	<u><b>1,739,607</b></u>
<b>COMMITMENTS AND CONTINGENCIES</b>		
Common stock (400 shares authorized, issued and outstanding; par value of \$37,500 per share) . . . . .	15,000	15,000
Additional paid-in capital . . . . .	813,002	794,797
Accumulated other comprehensive income [net of deferred income tax provision of \$70,889 and \$29,334] . . . . .	143,260	62,920
Accumulated earnings . . . . .	<u>1,000,063</u>	<u>825,955</u>
<b>TOTAL SHAREHOLDER'S EQUITY . . . . .</b>	<u><b>1,971,325</b></u>	<u><b>1,698,672</b></u>
<b>TOTAL LIABILITIES AND MINORITY INTEREST AND SHAREHOLDER'S EQUITY . . . . .</b>	<u><b>\$4,781,640</b></u>	<u><b>\$3,438,279</b></u>

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME**

(Dollars in thousands)

	Years Ended December 31,		
	2002	2001	2000
<b>REVENUES:</b>			
Net premiums written .....	\$535,956	\$319,638	\$218,138
Premiums earned .....	\$318,089	\$230,999	\$192,149
Net investment income .....	137,606	127,412	119,112
Net realized gains (losses) .....	28,399	6,282	(31,468)
Net realized and unrealized gains (losses) on derivatives .....	(87,396)	6,742	
Other income .....	6,018	1,097	1,445
<b>TOTAL REVENUES</b> .....	<b>402,716</b>	<b>372,532</b>	<b>281,238</b>
<b>EXPENSES:</b>			
Losses and loss adjustment expenses .....	65,613	12,497	9,403
Interest expense .....	12,174	5,762	6,000
Policy acquisition costs .....	54,093	41,375	37,602
Merger related expenses .....			33,912
Other operating expenses .....	46,373	38,436	33,143
<b>TOTAL EXPENSES</b> .....	<b>178,253</b>	<b>98,070</b>	<b>120,060</b>
Minority interest and equity in earnings of unconsolidated affiliates ..	2,461	(573)	(2,205)
<b>INCOME BEFORE INCOME TAXES</b> .....	<b>226,924</b>	<b>273,889</b>	<b>158,973</b>
Provision for income taxes:			
Current .....	68,033	45,361	23,913
Deferred .....	(23,888)	15,949	11,725
Total provision .....	44,145	61,310	35,638
<b>NET INCOME</b> .....	<b>182,779</b>	<b>212,579</b>	<b>123,335</b>
<b>OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX:</b>			
Unrealized gains (losses) on securities:			
Holding gains (losses) arising during period [net of deferred income tax provision (benefit) of \$49,196, \$(7,133) and \$47,664] .....	101,098	(2,291)	92,126
Less: reclassification adjustment for gains (losses) included in net income [net of deferred income tax provision (benefit) of \$7,641, \$1,940 and \$(10,375)] .....	20,758	4,342	(21,093)
Other comprehensive income (loss) .....	80,340	(6,633)	113,219
<b>COMPREHENSIVE INCOME</b> .....	<b>\$263,119</b>	<b>\$205,946</b>	<b>\$236,554</b>

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDER'S EQUITY**

(Dollars in thousands)

	<u>Common Stock</u>	<u>Additional Paid-In Capital</u>	<u>Unrealized Gain (Loss) on Investments</u>	<u>Accumulated Earnings</u>	<u>Total</u>
BALANCE, December 31, 1999 . . . . .	\$15,000	\$832,556	\$(43,666)	\$ 491,056	\$1,294,946
Net income . . . . .				123,335	123,335
Net change in accumulated comprehensive income (net of deferred income tax provision of \$58,040) . . . . .			113,219		113,219
Stock repurchase . . . . .		(55,000)			(55,000)
Deferred equity payout by Parent . . . . .		8,485			8,485
Capital contribution from Parent . . . . .		3,881			3,881
BALANCE, December 31, 2000 . . . . .	<u>15,000</u>	<u>789,922</u>	<u>69,553</u>	<u>614,391</u>	<u>1,488,866</u>
Net income . . . . .				212,579	212,579
Net change in accumulated comprehensive income (net of deferred income tax benefit of \$5,193) . . . . .			(6,633)		(6,633)
Dividends paid . . . . .				(1,589)	(1,589)
Capital contribution from Parent . . . . .		4,875			4,875
Other . . . . .				574	574
BALANCE, December 31, 2001 . . . . .	<u>15,000</u>	<u>794,797</u>	<u>62,920</u>	<u>825,955</u>	<u>1,698,672</u>
Net income . . . . .				182,779	182,779
Net change in accumulated comprehensive Income (net of deferred income tax benefit of \$41,555) . . . . .			80,340		80,340
Capital contribution from Parent . . . . .		18,205			18,205
Dividends paid . . . . .				(8,671)	(8,671)
BALANCE, December 31, 2002 . . . . .	<u>\$15,000</u>	<u>\$813,002</u>	<u>\$143,260</u>	<u>\$1,000,063</u>	<u>\$1,971,325</u>

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Dollars in thousands)**

	Years Ended December 31,		
	2002	2001	2000
Cash flows from operating activities:			
Premiums received, net	\$ 575,889	\$287,533	\$ 225,253
Policy acquisition and other operating expenses paid, net	(101,215)	(79,098)	(73,358)
Termination fee on derivative	(38,000)		
Recoverable advances recovered (paid)	5,010	(1,175)	1,495
Losses and loss adjustment expenses recovered (paid)	(2,403)	(18,687)	4,571
Net investment income received	127,144	119,744	106,039
Federal income taxes paid	(76,099)	(35,117)	(27,441)
Interest paid	(12,920)	(4,500)	(6,000)
Other	(1,682)	5,385	(208)
Net cash provided by operating activities	<u>475,724</u>	<u>274,085</u>	<u>230,351</u>
Cash flows from investing activities:			
Proceeds from sales of bonds	747,470	483,892	1,440,090
Purchases of bonds and securitized loans	(1,543,216)	(679,606)	(1,742,929)
Purchases of property and equipment	(5,591)	(4,218)	(3,727)
Net decrease (increase) in short-term investments	(150,328)	(99,407)	148,445
Other investments	6,080	1,672	(14,330)
Net cash used for investing activities	<u>(945,585)</u>	<u>(297,667)</u>	<u>(172,451)</u>
Cash flows from financing activities:			
Surplus notes issued	96,850	50,000	
Surplus notes repaid	(28,000)	(26,000)	
Issuance of notes payable	437,295		
Repayment of notes payable	(5,935)		
Capital contribution (a)			
Dividends paid	(8,671)	(1,589)	
Stock repurchase			(55,000)
Net cash provided (used) by financing activities	<u>491,539</u>	<u>22,411</u>	<u>(55,000)</u>
Net increase (decrease) in cash	21,678	(1,171)	2,900
Cash at beginning of year	5,882	7,053	4,153
Cash at end of year	<u>\$ 27,560</u>	<u>\$ 5,882</u>	<u>\$ 7,053</u>

(a) In 2002, 2001 and 2000, the Company received a tax benefit of \$18,205, \$4,875 and \$3,881, respectively, by utilizing its Parent's losses. These amounts were recorded as a capital contribution.

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.



**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**  
**(Dollars in thousands)**

	Years Ended December 31,		
	2002	2001	2000
Reconciliation of net income to net cash flows from operating activities:			
Net income . . . . .	\$182,779	\$212,579	\$123,335
Increase in accrued investment income . . . . .	(3,464)	(894)	(6,436)
Increase in deferred premium revenue and related foreign exchange adjustment . . . . .	223,018	86,825	23,668
Decrease (increase) in deferred acquisition costs . . . . .	(13,285)	(39,356)	(3,088)
Increase in current federal income taxes payable . . . . .	97	15,910	1,541
Increase (decrease) in unpaid losses and loss adjustment expenses . . . . .	62,120	(6,171)	13,903
Increase (decrease) in amounts withheld for others . . . . .		(1,271)	18
Provision for deferred income taxes . . . . .	(23,888)	15,949	11,725
Net realized losses (gains) on investments . . . . .	(28,399)	(6,282)	31,468
Depreciation and accretion of bond discount . . . . .	(4,334)	(4,504)	(5,005)
Minority interest and equity in earnings of unconsolidated affiliates . . . . .	(2,461)	573	2,205
Change in other assets and liabilities . . . . .	83,541	727	37,017
Cash provided by operating activities . . . . .	<u>\$475,724</u>	<u>\$274,085</u>	<u>\$230,351</u>

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**1. ORGANIZATION AND OWNERSHIP**

Financial Security Assurance Inc. (FSA or the Company), a wholly owned subsidiary of Financial Security Assurance Holdings Ltd. (the Parent), is an insurance company domiciled in the State of New York. The Company is engaged in providing financial guaranty insurance on asset-backed and municipal obligations. The Company's underwriting policy is to insure asset-backed and municipal obligations that it determines would be of investment-grade quality without the benefit of the Company's insurance. The asset-backed obligations insured by the Company are generally issued in structured transactions and are backed by pools of assets, such as residential mortgage loans, consumer or trade receivables, securities or other assets having an ascertainable cash flow or market value. The Company also insures synthetic asset-backed obligations that generally take the form of credit default swap (CDS) obligations or credit-linked notes that reference pools of securities or loans, with a defined deductible to cover credit risks associated with the referenced securities or loans. In addition, the Company insures guaranteed investment contracts (GICs) issued by FSA Capital Markets Services LLC and FSA Capital Management Services LLC (collectively, CMS), wholly owned subsidiaries of the Parent. The municipal obligations insured by the Company consist primarily of general obligation bonds that are supported by the issuers' taxing power and special revenue bonds and other special obligations of states and local governments that are supported by the issuers' ability to impose and collect fees and charges for public services or specific projects. Financial guaranty insurance written by the Company guarantees scheduled payments on an issuer's obligation. In the case of a payment default on an insured obligation, the Company is generally required to pay the principal, interest or other amounts due in accordance with the obligation's original payment schedule or, at its option, to pay such amounts on an accelerated basis.

The Company expects to continue to emphasize a diversified insured portfolio characterized by insurance of both asset-backed and municipal obligations, with a broad geographic distribution and a variety of revenue sources and transaction structures. The Company's insured portfolio consists primarily of asset-backed and municipal obligations originated in the United States of America, but the Company has also written and continues to pursue business in Europe and the Asia Pacific region.

On July 5, 2000, the Parent completed a merger in which the Parent became a direct subsidiary of Dexia Holdings Inc., which, in turn, is owned 90% by Dexia Crédit Local and 10% by Dexia S.A. (Dexia), a Belgium corporation whose shares are traded on the Euronext Brussels and Euronext Paris markets as well as on the Luxembourg Stock Exchange. The net effect of the merger, reflected in the December 31, 2000 financial statements, decreased net income by \$28.9 million. In addition, in connection with the merger, the Company repurchased \$55,000,000 of its stock from its Parent in July 2000.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP), which differ in certain material respects from the accounting practices prescribed or permitted by insurance regulatory authorities (see Note 5). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities in the Company's consolidated balance sheets at December 31, 2002 and 2001 and the reported amounts of revenues and expenses in the consolidated statements of operations and comprehensive income during the years ended December 31, 2002, 2001 and 2000. Such estimates and assumptions include, but are not limited to, losses and loss adjustment expenses and the deferral and

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

amortization of deferred policy acquisition costs. Actual results may differ from those estimates. Significant accounting policies under GAAP are as follows:

***Basis of Presentation***

The consolidated financial statements include the accounts of the Company and its direct and indirect subsidiaries, FSA Insurance Company, Financial Security Assurance International Ltd. (FSA International), and Financial Security Assurance (U.K.) Limited (collectively, the Subsidiaries). All intercompany accounts and transactions have been eliminated. Certain prior-year balances have been reclassified to conform to the 2002 presentation.

***Investments***

Investments in debt securities designated as available for sale are carried at market value. Equity investments are carried at market value. Any resulting unrealized gain or loss is reflected as a separate component of shareholder's equity, net of applicable deferred income taxes. All of the Company's debt and equity securities are classified as available for sale.

Bond discounts and premiums are amortized on the effective yield method over the remaining terms of the securities acquired. For mortgage-backed securities, and any other holdings for which prepayment risk may be significant, assumptions regarding prepayments are evaluated periodically and revised as necessary. Any adjustments required due to the resulting change in effective yields are recognized in current income. Short-term investments, which are those investments with a maturity of less than one year at time of purchase, are carried at market value, which approximates cost. Cash equivalents are amounts deposited in money market funds and investments with a maturity at time of purchase of three months or less and are included in short-term investments. Realized gains or losses on sale of investments are determined on the basis of specific identification. Investment income is recorded as earned.

Investments in unconsolidated affiliates are reported in other assets and are based on the equity method of accounting (see Note 16).

***Derivatives***

The Company has also insured a number of credit default swap agreements that it intends, in each case, to hold for the full term of the agreement. It considers these agreements to be a normal extension of its financial guaranty insurance business, although they are considered derivatives for accounting purposes. These agreements are recorded at fair value. The Company believes that the most meaningful presentation of the financial statement impact of these derivatives is to reflect premiums as installments are received, to record losses and loss adjustment expenses as incurred and to record changes in fair value as incurred. Changes in fair value are recorded in net realized and unrealized gains (losses) on derivative instruments and in other assets or other liabilities. The Company uses quoted market prices, when available, to determine fair value. If quoted prices are not available, management uses internally developed estimates. Due to a lack of a quoted market for the CDS obligations written by the Company, estimates generated from the Company's valuation process may differ materially from values that may be realized in market transactions.

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Premium Revenue Recognition***

Gross and ceded premiums are earned in proportion to the amount of risk outstanding over the expected period of coverage. The amount of risk outstanding is equal to the sum of the par amount of debt insured. Deferred premium revenue and prepaid reinsurance premiums represent the portion of premium that is applicable to coverage of risk to be provided in the future on policies in force. When an insured issue is retired or defeased prior to the end of the expected period of coverage, the remaining deferred premium revenue and prepaid reinsurance premium, less any amount credited to a refunding issue insured by the Company, are recognized.

***Losses and Loss Adjustment Expenses***

The Company establishes a case basis reserve for unpaid losses and loss adjustment expenses for the net present value of the estimated loss when, in management's opinion, the likelihood of a future loss on a particular insured obligation is probable and determinable at the balance sheet date. The estimated loss on a transaction is discounted using the then current risk-free rates ranging from 4.77% to 6.1%. For collateralized debt obligations (CDOs), a case basis reserve is recorded to the extent that the over-collateralization ratio (non-defaulted collateral at par value divided by the debt insured) has fallen below 100%.

The Company also maintains a non-specific general reserve, which is available to be applied against future additions or accretions to existing case basis reserves or to new case basis reserves to be established in the future. The general reserve is calculated by applying a loss factor to the total net par amount outstanding of the Company's insured obligations over the term of such insured obligations and discounting the result at the then current risk-free rates. The loss factor used for this purpose has been determined based upon an independent rating agency study of bond defaults and the Company's portfolio characteristics and history.

Management of the Company periodically evaluates its estimates for losses and loss adjustment expenses and establishes reserves that management believes are adequate to cover the net present value of the ultimate net cost of claims. The reserves are necessarily based on estimates, and there can be no assurance that the ultimate liability will not differ from such estimates. The Company will, on an ongoing basis, monitor these reserves and may periodically adjust such reserves based on the Company's actual loss experience, its future mix of business, and future economic conditions.

***Deferred Acquisition Costs***

Deferred acquisition costs comprise those expenses that vary with, and are primarily related to, the production of business, including commissions paid on reinsurance assumed, compensation and related costs of underwriting and marketing personnel, certain rating agency fees, premium taxes and certain other underwriting expenses, reduced by ceding commission income on premiums ceded to reinsurers. The Company does not defer acquisition costs relating to GICs issued by CMS, except for brokerage fees. Deferred acquisition costs and the cost of acquired business are amortized over the period in which the related premiums are earned. When an insured issue is retired or defeased prior to the end of the expected period of coverage, the remaining deferred acquisition cost is recognized. Recoverability of deferred acquisition costs is determined by considering anticipated losses and loss adjustment expenses.

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

***Federal Income Taxes***

The provision for income taxes consists of an amount for taxes currently payable and a provision for the deferred tax consequences of temporary differences between tax basis of assets and liabilities and that reported in the financial statements.

Non-interest bearing tax and loss bonds are purchased for the tax benefit resulting from deducting contingency reserves as provided under Internal Revenue Code Section 832(e). The Company records the purchase of tax and loss bonds as pre-payments of federal income taxes and includes them in other assets.

***Segment Reporting***

As a monoline financial guaranty insurer, the Company has no reportable operating segments.

**3. INVESTMENTS**

Bonds at amortized cost of \$8,474,000 and \$8,493,000 at December 31, 2002 and 2001, respectively, were on deposit with state regulatory authorities as required by insurance regulations.

Consolidated net investment income consisted of the following (in thousands):

	Years Ended December 31,		
	2002	2001	2000
Bonds . . . . .	\$136,352	\$125,531	\$114,021
Equity investments . . . . .	294	504	505
Short-term investments . . . . .	3,337	3,652	6,218
Investment expenses . . . . .	(2,377)	(2,275)	(1,632)
Net investment income . . . . .	<u>\$137,606</u>	<u>\$127,412</u>	<u>\$119,112</u>

The credit quality of bonds at December 31, 2002 was as follows:

<u>Rating</u>	<u>Percent of Bonds</u>
AAA	75.6%
AA	19.8
A	4.5
Other	0.1

Of the AAA rated bonds included in the investment portfolio, 8.7% were AAA by virtue of insurance provided by the Company.

**FINANCIAL SECURITY ASSURANCE INC.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**3. INVESTMENTS (Continued)**

The amortized cost and estimated market value of bonds were as follows (in thousands):

<u>December 31, 2002</u>	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Market Value</u>
U.S. Treasury securities and obligations of U.S. government corporations and agencies . . . . .	\$ 60,101	\$ 7,178	\$ (26)	\$ 67,253
Obligations of states and political Subdivisions . . . . .	2,034,691	186,352	(174)	2,220,869
Mortgage-backed securities . . . . .	250,092	8,203	(141)	258,154
Corporate securities . . . . .	177,934	10,547	(35)	188,446
Asset-backed securities . . . . .	74,781	2,244		77,025
Total . . . . .	<u>\$2,597,599</u>	<u>\$14,524</u>	<u>\$ (376)</u>	<u>\$2,811,747</u>
<u>December 31, 2001</u>	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Market Value</u>
U.S. Treasury securities and obligations of U.S. government corporations and agencies . . . . .	\$ 66,947	\$ 2,247	\$ (257)	\$ 68,937
Obligations of states and political Subdivisions . . . . .	1,692,288	78,706	(5,276)	1,765,718
Foreign securities . . . . .	5,780	806	6,586	
Mortgage-backed securities . . . . .	227,954	8,578	(549)	235,983
Corporate securities . . . . .	173,776	6,759	(710)	179,825
Asset-backed securities . . . . .	44,502	1,984	(104)	46,382
Total . . . . .	<u>\$2,211,247</u>	<u>\$ 99,080</u>	<u>\$(6,896)</u>	<u>\$2,303,431</u>

**FINANCIAL SECURITY ASSURANCE INC.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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**3. INVESTMENTS (Continued)**

The change in net unrealized gains (losses) consisted of (in thousands):

	Years Ended December 31,		
	2002	2001	2000
Bonds .....	\$121,964	\$(12,156)	\$171,187
Equity investments .....	(70)	330	72
Change in net unrealized gains (losses) .....	<u>\$121,894</u>	<u>\$(11,826)</u>	<u>\$171,259</u>

The amortized cost and estimated market value of bonds at December 31, 2002, by contractual maturity, are shown below (in thousands). Actual maturities could differ from contractual maturities because borrowers have the right to call or prepay certain obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Market Value
Due in one year or less .....	\$ 999	\$ 1,028
Due after one year through five years .....	141,441	148,059
Due after five years through ten years .....	261,060	288,388
Due after ten years .....	1,869,226	2,039,093
Mortgage-backed securities (stated maturities of 1 to 30 years) .....	250,092	258,154
Asset-backed securities (stated maturities of 1 to 14 years) .....	74,781	77,025
Total .....	<u>\$2,597,599</u>	<u>\$2,811,747</u>

Proceeds from sales of bonds during 2002, 2001 and 2000 were \$733,926,000, \$483,127,000 and \$1,404,050,000, respectively. Gross gains of \$29,302,000, \$8,007,000 and \$9,741,000 and gross losses of \$1,098, \$1,725,000 and \$41,145,000 were realized on sales in 2002, 2001 and 2000, respectively.

Equity investments had gross unrealized gains of \$75,000 and gross unrealized losses of \$5,000 as of December 31, 2001.

**FINANCIAL SECURITY ASSURANCE INC.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**4. DEFERRED ACQUISITION COSTS**

Acquisition costs deferred for amortization against future income and the related amortization charged to expenses are as follows (in thousands):

	Years Ended December 31,		
	2002	2001	2000
Balance, beginning of period . . . . .	\$240,492	\$201,136	\$198,048
Costs deferred during the period:			
Ceding commission income . . . . .	(68,464)	(41,935)	(42,496)
Premium taxes . . . . .	13,401	9,653	5,934
Compensation and other acquisition costs . . . . .	122,441	113,013	77,252
Total . . . . .	67,378	80,731	40,690
Costs amortized during the period . . . . .	(54,093)	(41,375)	(37,602)
Balance, end of period . . . . .	\$253,777	\$240,492	\$201,136

**5. STATUTORY ACCOUNTING PRACTICES**

GAAP for the Company differs in certain significant respects from accounting practices prescribed or permitted by insurance regulatory authorities. The principal differences result from the following statutory accounting practices:

- Upfront premiums on municipal business are recognized as earned when related principal and interest have expired rather than over the expected coverage period;
- Acquisition costs are charged to operations as incurred rather than as related premiums are earned;
- A contingency reserve (rather than a general reserve) is computed based on the following statutory requirements:
  - 1) For all policies written prior to July 1, 1989, an amount equal to 50% of cumulative earned premiums less permitted reductions plus
  - 2) For all policies written on or after July 1, 1989, an amount equal to the greater of 50% of premiums written for each category of insured obligation or a designated percentage of principal guaranteed for that category. These amounts are provided each quarter as either 1/60th or 1/80th of the total required for each category, less permitted reductions;
- Certain assets designated as "non-admitted assets" are charged directly to statutory surplus but are reflected as assets under GAAP;
- Bonds are carried at amortized cost; and
- Surplus notes are recognized as surplus rather than as a liability.



**FINANCIAL SECURITY ASSURANCE INC.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**5. STATUTORY ACCOUNTING PRACTICES (Continued)**

A reconciliation of net income for the calendar years 2002, 2001 and 2000 and shareholder's equity at December 31, 2002 and 2001, reported by the Company on a GAAP basis, to the amounts reported by the Subsidiaries on a statutory basis, is as follows (in thousands):

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Net Income:			
GAAP BASIS . . . . .	\$182,779	\$212,579	\$123,335
Premium revenue recognition . . . . .	(19,624)	(23,113)	(13,824)
Losses and loss adjustment expenses incurred . . . . .	20,585	3,867	10,233
Deferred acquisition costs . . . . .	(13,285)	(39,356)	(3,088)
Deferred income tax provision . . . . .	(23,888)	15,949	11,725
Current income tax benefit . . . . .	(8,162)	(6,239)	837
Change in fair value of derivatives . . . . .	48,788		
Accrual of deferred compensation, net . . . . .			(20,328)
Other . . . . .	7,895	9,383	4,869
STATUTORY BASIS . . . . .	<u>\$195,088</u>	<u>\$173,070</u>	<u>\$113,759</u>

	<u>December 31,</u>	
	<u>2002</u>	<u>2001</u>
Shareholder's Equity:		
GAAP BASIS . . . . .	\$1,971,325	\$1,698,672
Premium revenue recognition . . . . .	(162,788)	(141,365)
Loss and loss adjustment expense reserves . . . . .	89,656	69,071
Deferred acquisition costs . . . . .	(253,777)	(240,492)
Contingency reserve . . . . .	(691,955)	(784,591)
Unrealized gain on investments, net of deferred tax . . . . .	(214,148)	(92,254)
Deferred income taxes . . . . .	168,452	134,655
Surplus notes . . . . .	214,865	146,762
Other . . . . .	62,532	18,521
STATUTORY BASIS SURPLUS . . . . .	<u>\$1,184,162</u>	<u>\$ 808,979</u>
SURPLUS PLUS CONTINGENCY RESERVE . . . . .	<u>\$1,876,117</u>	<u>\$1,593,570</u>

The U.S. domiciled Subsidiaries file statutory-basis financial statements with state insurance departments in all states in which the Subsidiaries are licensed. On January 1, 2001, significant changes to the statutory basis of accounting became effective. The cumulative effect of these changes, known as Codification guidance, was recorded as a direct adjustment to statutory surplus. The effect of adoption on January 1, 2001 was a \$50,293,000 decrease to statutory surplus, which related primarily to the accrual of deferred compensation obligations.

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**6. FEDERAL INCOME TAXES**

Prior to the merger with Dexia, the Parent, the Company and its Subsidiaries, except FSA International, filed a consolidated federal income tax return. The calculation of each company's tax benefit or expense was controlled by a tax-sharing agreement that based the allocation of such benefit or expense upon a separate return calculation. Dexia Holdings, the Parent and the Company and its Subsidiaries, except FSA International, will file a consolidated federal income tax return for periods subsequent to the merger, under a new tax sharing agreement. The new tax sharing agreement provides that each member's tax benefit or expense is calculated on a separate return basis and that any credits or losses available to the Parent or Dexia Holdings be allocated to the members based on the member's taxable income. At December 31, 2002 and 2001, the Company and its Subsidiaries received benefits from utilizing the Parent's credits and losses of \$18,205,000 and \$4,875,000, respectively. These amounts have been recorded as capital contributions and reductions in amounts payable to the Parent in the financial statements.

Federal income taxes have not been provided on substantially all of the undistributed earnings of FSA International, since it is the Company's practice and intent to reinvest such earnings in the operations of these subsidiaries. The cumulative amount of such untaxed earnings was \$57,063,000, \$41,899,000 and \$18,629,000 at December 31, 2002, 2001 and 2000, respectively.

The cumulative balance sheet effects of deferred federal tax consequences are as follows (in thousands):

	<b>December 31,</b>	
	<b>2002</b>	<b>2001</b>
Deferred acquisition costs . . . . .	\$ 80,815	\$ 78,008
Deferred premium revenue adjustments . . . . .	17,663	17,420
Unrealized capital gains . . . . .	71,734	30,179
Contingency reserves . . . . .	78,433	70,350
Undistributed earnings . . . . .	2,195	1,340
Mark-to-market adjustments . . . . .		2,092
Other, net . . . . .	574	
Total deferred federal income tax liabilities . . . . .	<u>251,414</u>	<u>199,389</u>
Loss and loss adjustment expense reserves . . . . .	(27,526)	(21,384)
Deferred compensation . . . . .	(54,990)	(43,466)
Mark-to-market adjustments . . . . .	(15,565)	
Other, net . . . . .		(662)
Total deferred federal income tax assets . . . . .	<u>(98,081)</u>	<u>(65,512)</u>
Total deferred federal income taxes . . . . .	<u>\$153,333</u>	<u>\$133,877</u>

No valuation allowance was necessary at December 31, 2002 or 2001.

**FINANCIAL SECURITY ASSURANCE INC.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**6. FEDERAL INCOME TAXES (Continued)**

A reconciliation of the effective tax rate with the federal statutory rate follows:

	<u>Years Ended December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
Tax at statutory rate . . . . .	35.0%	35.0%	35.0%
Tax-exempt interest . . . . .	(13.2)	(9.6)	(14.3)
Income of foreign subsidiary . . . . .	(2.3)	(3.0)	(2.6)
Merger-related expenses . . . . .			4.2
Other . . . . .	0.0	0.0	0.1
Provision for income taxes . . . . .	<u>19.5%</u>	<u>22.4%</u>	<u>22.4%</u>

**7. DIVIDENDS AND CAPITAL REQUIREMENTS**

Under New York Insurance Law, the Company may pay a dividend without the prior approval of the Superintendent of Insurance of the State of New York (the New York Superintendent) only from earned surplus subject to the maintenance of a minimum capital requirement. In addition, the dividend, together with all dividends declared or distributed by it during the preceding twelve months, may not exceed the lesser of 10% of its policyholders' surplus shown on its last filed statement, or adjusted net investment income, as defined, for such twelve-month period. As of December 31, 2002, the Company had \$113,983,000 available for the payment of dividends over the next twelve months. However, as a customary condition for approving the application of Dexia for a change in control of the Company, the prior approval of the New York Superintendent is required for any payment of dividends by the Company for a period of two years following such change in control, which began July 5, 2000. In 2002 and 2001, FSA International paid a preferred dividend of \$8,671,000 and \$1,589,000, respectively, to its minority interest owner.

**8. CREDIT ARRANGEMENTS AND ADDITIONAL CLAIMS-PAYING RESOURCES**

The Company has a credit arrangement aggregating \$125,000,000 at December 31, 2002, which is provided by commercial banks and intended for general application to transactions insured by the Company and the Subsidiaries. At December 31, 2002, there were no borrowings under this arrangement, which expires on April 26, 2003, if not extended. In addition, there are credit arrangements assigned to specific insured transactions. In August 1994, the Company entered into a facility agreement with Canadian Global Funding Corporation and Hambros Bank Limited. Under the agreement, which expires in August 2004, the Company can arrange financing for transactions subject to certain conditions. The amount of this facility was \$186,911,000, of which \$125,161,000 was unutilized at December 31, 2002.

The Company has a standby line of credit commitment in the amount of \$240,000,000 with a group of international banks to provide loans to the Company after it has incurred, during the term of the facility, cumulative municipal losses (net of any recoveries) in excess of the greater of \$240,000,000 or the average annual debt service of the covered portfolio multiplied by 5.00%, which amounted to \$704,553,000 at December 31, 2002. The obligation to repay loans made under this agreement is a limited recourse obligation payable solely from, and collateralized by, a pledge of recoveries realized on defaulted insured

**FINANCIAL SECURITY ASSURANCE INC.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**8. CREDIT ARRANGEMENTS AND ADDITIONAL CLAIMS-PAYING RESOURCES (Continued)**

obligations in the covered portfolio, including certain installment premiums and other collateral. This commitment has a term expiring on April 30, 2009 and contains an annual renewal provision subject to approval by the banks. No amounts have been utilized under this commitment as of December 31, 2002.

The Company had borrowed \$120,000,000 from its Parent in the form of Surplus Notes. These notes carry a simple interest rate of 5.0% per annum. Principal of and interest on the Surplus Notes may be paid at any time at the option of the Company, subject to prior approval of the New York Superintendent and compliance with the conditions to such payments as contained in the New York Insurance Laws. These notes have no stated maturity. The Company paid interest of \$7,309,000, \$4,500,000 and \$6,000,000 in 2002, 2001 and 2000, respectively. In 2002 and 2001, with the approval of the New York Superintendent, the Company repaid \$28,000,000 and \$26,000,000, respectively, of principal on such notes and subsequently issued an additional \$96,850,000 and \$50,000,000 in 2002 and 2001, respectively, of notes to its Parent. As of December 31, 2002, the amount of surplus notes outstanding was \$212,850,000.

**9. EMPLOYEE BENEFIT PLANS**

The Company and its Parent maintain both qualified and non-qualified, non-contributory defined contribution pension plans for the benefit of all eligible employees. The Company and its Parent's contributions are based upon a fixed percentage of employee compensation. Pension expense, which is funded as accrued, amounted to \$4,761,000, \$3,328,000 and \$3,354,000, respectively, for the years ended December 31, 2002, 2001 and 2000, respectively.

The Company has an employee retirement savings plan for the benefit of all eligible employees. The plan permits employees to contribute a percentage of their salaries up to limits prescribed by IRS Code, Section 401(k). The Company's contributions are discretionary, and none have been made.

Performance shares are awarded under the Parent's 1993 Equity Participation Plan. The Plan authorizes the discretionary grant of performance shares by the Human Resources Committee to key employees of the Company. The amount earned for each performance share depends upon the attainment by the Parent of certain growth rates of adjusted book value (or in the case of performance shares issued on or after January 1, 2001, growth in adjusted book value and book value) per outstanding share over a three-year period. No payout occurs if the compound annual growth rate of the Parent's adjusted book value per outstanding share was less than 7% and 200% payout occurs if the compound annual growth rate was 19% or greater. Payout percentages are interpolated for compound annual growth rates between 7% and 19%.

Performance shares granted under the 1993 Equity Participation Plan were as follows:

	Outstanding at Beginning of Year	Granted During the Year	Earned During the Year	Forfeited During the Year	Outstanding at End of Year	Price per Share at Grant Date
2000 . . . . .	1,223,025	437,300	540,710	24,781	1,094,834	52.1250
2001 . . . . .	1,094,834	310,200	261,034	12,250	1,131,750	79.0400
2002 . . . . .	1,131,750	376,775	380,279	13,901	1,114,345	85.6300

**FINANCIAL SECURITY ASSURANCE INC.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
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**9. EMPLOYEE BENEFIT PLANS (Continued)**

The Company applies APB Opinion 25 and related Interpretations in accounting for the Parent's performance shares. The Company estimates the final cost of these performance shares and accrues for this expense over the performance period. The accrued expense for the performance shares was \$55,844,000, \$46,371,000 and \$34,248,000, for the years ended December 31, 2002, 2001 and 2000, respectively. The accrued expense for 2000 includes \$12,076,000 of merger related costs. Prior to the merger, the performance shares were adjusted to payout from 0 to two common shares of the Parent. The Company recognized a benefit for the difference between the market value of the Parent's common stock and the cost of the stock when it was purchased by an independent trustee (which amount was reimbursed by the Company to its Parent) for shares distributed under the performance share plan. This benefit was recorded by the Company as a capital contribution which totaled \$8,485,000 in 2000. Had the compensation cost for the Parent's performance shares been determined based upon the provisions of SFAS No. 123, there would have been no effect on the Company's reported net income.

The Company does not currently provide post-retirement benefits, other than under its defined contribution plans, to its employees, nor does it provide post-employment benefits to former employees other than under its severance plans or employment agreements with members of senior management.

**10. COMMITMENTS AND CONTINGENCIES**

The Company leases office space and equipment under non-cancelable operating leases, which expire at various dates through 2007.

Future minimum rental payments are as follows (in thousands):

<u>Year Ended December 31,</u>	
2003 . . . . .	\$ 5,531
2004 . . . . .	5,397
2005 . . . . .	4,349
2006 . . . . .	1,460
2007 . . . . .	<u>841</u>
Total . . . . .	<u>\$17,578</u>

Rent expense for the years ended December 31, 2002, 2001 and 2000 was \$5,716,000, \$5,852,000 and \$4,745,000 respectively.

During the ordinary course of business, the Company and its Subsidiaries have become parties to certain litigation. Management believes that these matters will be resolved with no material impact on the Company's financial position, results of operations or cash flows.

**11. REINSURANCE**

The Subsidiaries obtain reinsurance to increase its policy writing capacity, both on an aggregate risk and a single risk basis, to meet state insurance regulatory, rating agency and internal limits, diversify risk,

**FINANCIAL SECURITY ASSURANCE INC.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**11. REINSURANCE (Continued)**

reduce the need for additional capital and strengthen financial ratios. The Subsidiaries reinsure portions of their risks with affiliated (see Note 13) and unaffiliated reinsurers under quota share, first-loss and excess-of-loss treaties and on a facultative basis.

In the event that any or all of the reinsuring companies were unable to meet their obligations to the Company, or contested such obligations, the Company would be liable for such defaulted amounts. Certain of the reinsuring companies have provided collateral to the Subsidiaries to secure their reinsurance obligations. The Company has also assumed reinsurance of municipal obligations from unaffiliated insurers.

Amounts reinsured were as follows (in thousands):

	Year Ended December 31,		
	2002	2001	2000
Written premiums ceded . . . . .	\$270,954	\$165,932	\$154,187
Written premiums assumed . . . . .	2,443	3,130	9,702
Earned premiums ceded . . . . .	134,093	99,251	85,175
Earned premiums assumed . . . . .	4,079	3,653	3,312
Losses and loss adjustment expense payments ceded . . . . .	(2,513)	(4,199)	1,616
Losses and loss adjustment expense payments assumed . . . . .			26
	December 31,		
	2002	2001	
Principal outstanding ceded . . . . .	\$92,141,112	\$75,407,703	
Principal outstanding assumed . . . . .	2,000,422	2,171,588	
Deferred premium revenue ceded . . . . .	557,659	420,798	
Deferred premium revenue assumed . . . . .	13,331	14,967	
Losses and loss adjustment expense reserves ceded . . . . .	75,950	28,880	
Losses and loss adjustment expense reserves assumed . . . . .	728	703	

**FINANCIAL SECURITY ASSURANCE INC.  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**12. OUTSTANDING EXPOSURE AND COLLATERAL**

The Company's policies insure the scheduled payments of principal and interest on asset-backed and municipal obligations. The principal amount insured (in millions) as of December 31, 2002 and 2001 (net of amounts ceded to other insurers) and the terms to maturity are as follows:

Terms to Maturity	December 31, 2002		December 31, 2001	
	Asset-Backed(1)	Municipal	Asset-Backed(1)	Municipal
0 to 5 Years . . . . .	\$ 64,158	\$ 8,781	\$ 39,913	\$ 4,483
5 to 10 Years . . . . .	33,908	18,221	32,373	12,508
10 to 15 Years . . . . .	4,781	31,936	11,763	22,738
15 to 20 Years . . . . .	1,667	33,809	1,260	29,101
20 Years and Above . . . . .	24,009	44,430	26,204	36,768
Total . . . . .	<u>\$128,523</u>	<u>\$ 137,177</u>	<u>\$111,513</u>	<u>\$105,598</u>

- (1) Includes \$2,430 million and \$479 million, in 2002 and 2001, respectively, relating to FSA-insured GICs issued by CMS that are excluded from the Parent's consolidated exposures. The consolidated financial statements of the Parent reflect the FSA-insured GICs as GIC liabilities instead of as insurance exposure because CMS is consolidated with the Parent.

The principal amount ceded as of December 31, 2002 and 2001 and the terms to maturity are as follows (in millions):

Terms to Maturity	December 31, 2002		December 31, 2001	
	Asset-Backed	Municipal	Asset-Backed	Municipal
0 to 5 Years . . . . .	\$10,130	\$ 2,130	\$ 8,386	\$ 1,979
5 to 10 Years . . . . .	6,851	4,628	5,907	3,606
10 to 15 Years . . . . .	3,699	10,105	2,251	8,841
15 to 20 Years . . . . .	1,428	16,433	1,140	12,514
20 Years and Above . . . . .	5,906	30,830	5,282	25,501
Total . . . . .	<u>\$28,014</u>	<u>\$64,126</u>	<u>\$22,966</u>	<u>\$52,441</u>

The Company limits its exposure to losses from writing financial guarantees by underwriting investment-grade obligations, diversifying its portfolio and maintaining rigorous collateral requirements on asset-backed obligations, as well as through reinsurance. The gross principal amounts of insured obligations in the asset-backed insured portfolio are backed by the following types of collateral (in millions):

Types of Collateral	Net of Amounts Ceded(1) December 31,		Ceded December 31,	
	2002	2001	2002	2001
Residential mortgages . . . . .	\$ 23,379	\$ 26,084	\$ 5,954	\$ 4,554
Consumer receivables . . . . .	19,454	19,856	5,480	4,981
Pooled corporate obligations . . . . .	78,113	61,412	13,007	11,839

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**12. OUTSTANDING EXPOSURE AND COLLATERAL (Continued)**

Types of Collateral	Net of Amounts Ceded(1) December 31,		Ceded December 31,	
	2002	2001	2002	2001
Investor-owned utility obligations . . . . .	619	598	348	314
Other asset-backed obligations . . . . .	6,958	3,563	3,225	1,278
Total asset-backed obligations . . . . .	<u>\$128,523</u>	<u>\$111,513</u>	<u>\$28,014</u>	<u>\$22,966</u>

- (1) Includes \$2,430 million and \$479 million, in 2002 and 2001, respectively, relating to FSA-insured GICs issued by CMS that are excluded from the Parent's consolidated exposures. The consolidated financial statements of the Parent reflect the FSA-insured GICs as GIC liabilities instead of as insurance exposure because CMS is consolidated with the Parent.

The gross principal amount of insured obligations in the municipal insured portfolio includes the following types of issues (in millions):

Types of Issues	Net of Amounts Ceded December 31,		Ceded December 31,	
	2002	2001	2002	2001
General obligation bonds . . . . .	\$ 54,563	\$ 42,692	\$18,388	\$15,512
Housing revenue bonds . . . . .	5,833	4,717	1,687	1,557
Municipal utility revenue bonds . . . . .	23,442	16,497	13,468	10,955
Health care revenue bonds . . . . .	5,970	5,642	6,683	6,004
Tax-supported bonds (non-general obligation) . . . . .	27,556	21,982	12,391	10,143
Transportation revenue bonds . . . . .	7,640	5,391	5,748	4,760
Other municipal bonds . . . . .	12,173	8,677	5,761	3,510
Total municipal obligations . . . . .	<u>\$137,177</u>	<u>\$105,598</u>	<u>\$64,126</u>	<u>\$52,441</u>

In its asset-backed business, the Company considers geographic concentration as a factor in underwriting insurance covering securitizations of pools of such assets as residential mortgages or consumer receivables. However, after the initial issuance of an insurance policy relating to such securitizations, the geographic concentration of the underlying assets may not remain fixed over the life of the policy. In addition, in writing insurance for other types of asset-backed obligations, such as securities primarily backed by government or corporate debt, geographic concentration is not deemed by the Company to be significant, given other more relevant measures of diversification, such as issuer or industry diversification.

The Company seeks to maintain a diversified portfolio of insured municipal obligations designed to spread its risk across a number of geographic areas. The following table sets forth those states in which



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**12. OUTSTANDING EXPOSURE AND COLLATERAL (Continued)**

municipalities located therein issued an aggregate of 2% or more of the Company's net par amount outstanding of insured municipal securities as of December 31, 2002:

<u>State</u>	<u>Number of Issues</u>	<u>Net Par Amount Outstanding (in millions)</u>	<u>Percent of Total Municipal Net Par Amount Outstanding</u>	<u>Ceded Par Amount Outstanding (in millions)</u>
California . . . . .	837	\$ 19,379	14.1%	\$ 7,299
New York . . . . .	550	13,256	9.7	8,620
Texas . . . . .	615	10,052	7.3	4,716
Pennsylvania . . . . .	580	8,496	6.2	2,799
Florida . . . . .	230	7,602	5.5	3,161
Illinois . . . . .	580	6,697	4.9	2,988
New Jersey . . . . .	445	6,322	4.6	3,545
Washington . . . . .	239	5,020	3.7	2,506
Massachusetts . . . . .	172	4,088	3.0	2,197
Michigan . . . . .	340	3,864	2.8	1,345
Wisconsin . . . . .	393	3,529	2.6	739
All other U.S. jurisdictions . .	2,622	45,399	33.1	20,481
International . . . . .	40	3,473	2.5	3,730
Total . . . . .	<u>7,643</u>	<u>\$137,177</u>	<u>100.0%</u>	<u>\$64,126</u>

**13. RELATED PARTY TRANSACTIONS**

Allocable expenses are shared by the Company and its Parent on a basis determined principally by estimates of respective usage as stated in an expense sharing agreement. The agreement is subject to the provisions of the New York Insurance Law. Amounts included in other assets at December 31, 2002 and 2001 are \$8,162,000 and \$2,572,000, respectively, for unsettled expense allocations due from the Parent.

The Company ceded premiums of \$30,701,000 to Tokio Marine and Fire Insurance Co., Ltd. (Tokio Marine), a partial owner of the Parent prior to the merger, for the year ended December 31, 2000. The Company ceded losses and loss adjustment expenses of \$2,935,000 to Tokio Marine for the year ended December 31, 2000. The Company ceded premiums of \$23,393,000, \$12,795,000 and \$22,581,000 to XL Capital Ltd. (XL) and its subsidiaries, for the years ended December 31, 2002, 2001 and 2000, respectively. The amounts included in prepaid reinsurance premiums at December 31, 2002 and 2001 for reinsurance ceded to XL and its subsidiaries were \$31,976,000 and \$27,509,000, respectively.

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**13. RELATED PARTY TRANSACTIONS (Continued)**

The Company ceded premiums of \$(1,401,000) on a quota share basis to Commercial Reinsurance Company (Comm Re), an affiliate of MediaOne Capital Corporation (MediaOne), a partial owner of the Parent prior to the merger, for the year ended December 31, 2000. The Company assumed premiums of \$8,568,000 from Comm Re for the year ended December 31, 2000, in connection with the acquisition of Comm Re. The sellers have either posted a letter of credit or assumed Comm Re's exposure themselves to cover any losses on its exposure at the time of the acquisition, all of which is being accounted for as reinsurance by the Company. The Company ceded losses and loss adjustment expense recoveries of \$501,000 to this affiliate for the year ended December 31, 2000.

The Company had premiums written of \$59,103,000, \$54,295,000 and \$4,412,000 in 2002, 2001 and 2000, respectively, relating to the guaranty of debt issued by and of debt obligations purchased by FSA Global Funding Limited (Global), a 29% owned investment of the Company's Parent. The amounts included in deferred premium revenue relating to Global transactions are \$35,452,000 and \$40,090,000 at December 31, 2002 and 2001, respectively.

The Company had premiums earned of \$17,272,000 and \$7,159,000 for the years ended December 31, 2002 and 2001, respectively, relating to business with affiliates of Dexia. Deferred premium revenue was \$7,675,000 and \$4,336,000 and gross par outstanding relating to those transactions \$16,165,980,000 and \$10,906,755,000, at December 31, 2002 and 2001, respectively.

The Company had premiums earned of \$3,209,000 relating to the guaranty of GICs issued by CMS.

**14. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS**

The following estimated fair values have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is necessary to interpret the data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amount the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

Bonds and equity investments—The carrying amount represents fair value. The fair value is based upon quoted market price.

Short-term investments—The carrying amount is fair value, which approximates cost due to the short maturity of these instruments.

Cash, receivable for investments sold and payable for investments purchased—The carrying amount approximates fair value because of the short maturity of these instruments.

Securitized loans—The carrying amount is cost. The fair value of the loans is the present value of the expected cash flows as of the reporting date.

Deferred premium revenue, net of prepaid reinsurance premiums—The carrying amount of deferred premium revenue, net of prepaid reinsurance premiums, represents the Company's future premium revenue, net of reinsurance, on policies where the premium was received at the inception of the insurance contract. The fair value of deferred premium revenue, net of prepaid reinsurance premiums, is an estimate

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**14. DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)**

of the premiums that would be paid under a reinsurance agreement with a third party to transfer the Company's financial guaranty risk, net of that portion of the premiums retained by the Company to compensate it for originating and servicing the insurance contract.

Installment premiums—Consistent with industry practice, there is no carrying amount for installment premiums since the Company will receive premiums on an installment basis over the term of the insurance contract. Similar to deferred premium revenue, the fair value of installment premiums is the estimated present value of the future contractual premium revenues that would be paid under a reinsurance agreement with a third party to transfer the Company's financial guaranty risk, net of that portion of the premium retained by the Company to compensate it for originating and servicing the insurance contract.

Long-term debt—The Company could not determine the fair value of the notes because the related party debt does not contain normal commercial terms such as a maturity date.

Notes payable to affiliate—The fair value of a is the present value of the expected cash flows as of the reporting date.

Losses and loss adjustment expenses, net of reinsurance recoverable on unpaid losses—The carrying amount is fair value, which is the net present value of the expected cash flows for specifically identified claims and potential losses in the Company's insured portfolio.

	December 31, 2002		December 31, 2001	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
	(in thousands)			
Assets:				
Bonds . . . . .	\$2,811,747	\$2,811,747	\$2,303,431	\$2,303,431
Equity investments . . . . .			10,070	10,070
Short-term investments . . . . .	364,565	364,565	213,212	213,212
Cash . . . . .	27,560	27,560	5,882	5,882
Securitized loans . . . . .	431,718	437,231		
Receivable for securities sold . . . . .	93	93	3,636	3,636
Liabilities:				
Deferred premium revenue, net of prepaid reinsurance premiums . . . . .	892,552	738,738	669,534	567,629
Losses and loss adjustment expenses, net of reinsurance recoverable on unpaid losses . . . . .	147,668	147,668	85,548	85,548
Notes payable to affiliate . . . . .	431,360	440,589		
Long-term debt . . . . .	212,850	N/A	144,000	N/A
Payable for investments purchased . . . . .	2,481	2,481	28,214	28,214
Off-balance-sheet instruments:				
Installment premiums . . . . .		412,758		389,479

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000**

**15. LIABILITY FOR LOSSES AND LOSS ADJUSTMENT EXPENSES**

Activity in the liability for losses and loss adjustment expenses, which consists of the case basis and general reserves, is summarized as follows (in thousands):

	Year Ended December 31,		
	2002	2001	2000
Balance at January 1 . . . . .	\$114,428	\$116,336	\$ 87,309
Less reinsurance recoverable . . . . .	28,880	24,617	9,492
Net balance at January 1 . . . . .	85,548	91,719	77,817
Incurred losses and loss adjustment expenses:			
Current year . . . . .	21,133	8,203	6,672
Prior years . . . . .	44,480	4,294	2,731
Recovered (paid) losses and loss adjustment expenses, net:			
Prior years . . . . .	(3,493)	(18,668)	4,499
Net balance December 31 . . . . .	147,668	85,548	91,719
Plus reinsurance recoverable . . . . .	75,950	28,880	24,617
Balance at December 31 . . . . .	<u>\$223,618</u>	<u>\$114,428</u>	<u>\$116,336</u>

During 2000, the Company increased its general reserve by \$9,403,000, of which \$6,672,000 was for originations of new business and \$2,731,000 was for the accretion of the discount on prior years' reserves. Also during 2000, the Company transferred to the general reserve \$2,053,000 representing recoveries received on prior-year transactions and transferred \$1,223,000 from the general reserve to case basis reserves. Giving effect to these transfers, the general reserve totaled \$65,204,000 at December 31, 2000.

During 2001, the Company increased its general reserve by \$12,497,000, of which \$8,203,000 was for originations of new business and \$4,294,000 was for the accretion of the discount on prior years' reserves. Also during 2001, the Company transferred to the general reserve \$89,000 representing recoveries received on prior-year transactions and transferred \$8,719,000 from the general reserve to case basis reserves. Giving effect to these transfers, the general reserve totaled \$69,071,000 at December 31, 2001.

In the second quarter of 2002, as part of the Company's ongoing credit review process, management identified certain transactions not performing as expected in its portfolio of insured collateralized debt obligations (CDOs). As a result, management analyzed all CDO transactions in its insured portfolio that breached overcollateralization triggers, which were included in such transactions as one measure of adverse performance. A present value "deterministic" approach was utilized to estimate the loss inherent in this portfolio. The deterministic model applies a run of the collateral portfolio for each transaction considering each CDO transaction's unique attributes (such as reinsurance, individual collateral ratings and status, derivatives purchased, premiums due to the guarantor, etc.) utilizing a Moody's default pattern for frequency of defaults, an estimate of collateral recovery values for severity, and a risk-free rate of interest. Management assumed that current default rates on CDO collateral would improve in a manner consistent with an economic recovery following a period of significant credit deterioration similar to that experienced in 1991/1992 and, as a result, management selected Moody's 1992 idealized default curve as a predictor of future defaults on the CDO collateral. The per period default rate was calculated based on the Moody's weighted average rating factor for each piece of surviving collateral. Recovery rates were

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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**15. LIABILITY FOR LOSSES AND LOSS ADJUSTMENT EXPENSES (Continued)**

judgmentally established by the Company. In considering the recovery rates to be utilized, management adjusted Moody's average recovery rates (observed since 1982) downward to reflect more recent and more adverse observations. At June 30, 2002, this analysis produced a present value of expected losses of \$51.5 million, net of reinsurance recoveries and net of unearned premiums and future ceding commissions. As described in more detail below, management addressed this net present value of expected loss (\$51.5 million) through (i) an increase in the Company's general reserve (\$31.0 million) and (ii) amounts already existing in its general reserve (\$20.5 million), including general reserve amounts reallocated to case basis reserves (\$11.3 million). The \$31.0 million increase in the Company's general reserve resulted in a corresponding increase to losses and loss adjustment expense in the income statement of \$31.0 million. An additional adjustment of \$10.1 million was made in the fourth quarter of 2002 as a result of further deterioration of the CDO portfolio. Management has established a methodology of recording case basis reserves on CDO transactions to the extent that the overcollateralization ratio (non-defaulted collateral at par value divided by the debt insured) has fallen below 100%, since management believes that claims on such transactions are probable and that the amount of the undercollateralization is a reasonable estimate of such claims. Such transactions may benefit from excess cash flow attributable in part to higher interest rates on the underlying collateral than on the insured securities. In addition, such transactions generally require insured payments of principal only at the ultimate maturity of such transactions. As a result, the Company does not expect to be required to pay claims in respect of these transactions until 2010, but may elect to do so at an earlier date at its discretion. Application of this methodology resulted in recording \$68.8 million in gross case basis reserves and \$29.8 million in reinsurance recoverable on unpaid losses, resulting in a \$39.0 million increase in net case basis reserves. Management, beginning in the second quarter of 2002, has refined the loss factor it applies to its net par underwritten when calculating the general reserve in order to reflect its recent adverse experience. As a result, the general reserve accrual for the year ended December 31, 2002 was \$65.6 million, rather than the approximate \$14.9 million that would have been accrued using the prior assumptions.

During 2002, the Company increased its general reserve by \$65.6 million, of which \$41.1 million related to the CDO portfolio discussed above, \$21.1 million was for originations of new business and \$3.4 million was for the accretion of the discount on prior years' reserves. Also during 2002, the Company transferred to the general reserve \$0.8 million representing recoveries received on prior-year transactions and transferred \$45.8 million from the general reserve to case basis reserves. Giving effect to these transfers, the general reserve totaled \$89.7 million at December 31, 2002.

The cumulative amount of discount taken was approximately \$44,690,000, \$29,578,000 and \$28,748,000 at December 31, 2002, 2001 and 2000, respectively.

**16. INVESTMENTS IN UNCONSOLIDATED AFFILIATE**

In November 1998, the Parent invested \$19,900,000 to purchase a 19.9% interest in XL Financial Assurance Ltd (XLFA), a financial guaranty insurance subsidiary of XL. In February 1999, the Parent sold \$4,900,000 of its interest back to XLFA, giving the Parent a 15.0% interest in XLFA, which it contributed to the Company in December 1999. In December 2000, the Company invested an additional \$24,000,000 to maintain its 15.0% interest. The Company's investment in XLFA is accounted for using the equity method of accounting because the Company has significant influence over XLFA's operations. Amounts recorded

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**16. INVESTMENTS IN UNCONSOLIDATED AFFILIATE (Continued)**

by the Company in connection with XLFA as of December 31, 2002, 2001 and 2000 are as follows (in thousands):

	2002	2001	2000
Investment in XLFA . . . . .	\$52,206	\$49,726	\$43,721
Equity in earnings from XLFA . . . . .	9,145	8,356	3,090
Dividends received from XLFA . . . . .	6,665	1,492	859

At December 31, 2002 and 2001, the Company's retained earnings included \$13,206,000 and \$9,287,000, respectively, of accumulated undistributed earnings of XLFA.

**17. MINORITY INTEREST IN SUBSIDIARY**

In November 1998, FSA International, a Bermuda-based financial guaranty subsidiary of the Company, sold to XL \$20,000,000 of preferred shares representing a minority interest in FSA International. In December 1999, FSA International sold to XL an additional \$10,000,000 of preferred shares to maintain its minority ownership percentage. The preferred shares are Cumulative Participating Voting Preferred Shares, which in total have a minimum fixed dividend of \$1,500,000 per annum. For the years ended December 31, 2002, 2001 and 2000, the Company recognized minority interest of \$6,684,000, \$8,929,000 and \$5,295,000, respectively.

**18. SECURITIZED LOANS AND NOTES PAYABLE TO AFFILIATE**

In 2002, the Company exercised certain rights available under its financial guaranty policy and the indenture relating to loan-backed notes issued by FMAC Loan Receivables Trust 1998-D and 2000-A (the Trusts). Those rights allowed the Company to accelerate the insured notes and pay claims under its insurance policy on an accelerated basis. Refinancing vehicles reimbursed the Company in whole for its claims payment in exchange for an assignment of certain of the Company's rights against the Trusts. The refinancing vehicles secured the funds to purchase the notes by issuing notes with interest rates ranging from 2.406% to 5.718%. These notes were purchased by FSA Asset Management LLC (AMC), a wholly owned subsidiary of the Parent. The Company maintains significant reinsurance, first loss and quota share, under this transaction.

Since the notes represented 100% of the debt capitalization of the Trusts and since the Company maintains all of the risk of further asset decline and maintains control over key decisions regarding the Trusts (such as removal of servicer, sale of assets and liquidation of the entity), the Company consolidated the Trusts.

Although the securitized loans are included on the Company's balance sheet, the securitized loans continue to support FSA-insured transactions exclusively, subject to considerable first loss and quota share reinsurance. In accordance with AICPA Practice Bulletin 6, "Amortization of Discounts on Certain Acquired Loan", the Company has recorded the securitized loans at cost, has determined net cash flows from the pool of securitized loans and is recording income based upon the constant yield method. The cash flows on the securitized loans will be monitored and the constant yield modified to reflect any change in cash flow estimates.

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**18. SECURITIZED LOANS AND NOTES PAYABLE TO AFFILIATE (Continued)**

As a result of this transaction, the Company recorded \$431,718,000 of securitized loans and \$431,360,000 of notes payable. The Company recorded \$5,294,000 of other income on the securitized loans and \$4,861,000 of interest expense on the notes payable for the year ended December 31, 2002.

Principal payments due under these notes for each of the next five years ending December 31 and thereafter, are as follows (in millions):

<u>Expected Withdrawal Date</u>	<u>Principal Amount</u>
2003 .....	\$ 17.6
2004 .....	47.0
2005 .....	37.1
2006 .....	35.0
2007 .....	33.0
Thereafter .....	261.7
Total .....	<u>\$431.4</u>

**19. STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 133**

In August 2002, the single-name credit default swap program was terminated in exchange for paying termination costs of \$43.0 million, \$38.0 million of which was related to the Company's exposure. The charge was included in net realized and unrealized gains (losses) on derivative instruments in the consolidated statements of operations and comprehensive income.

The Company has also insured a number of credit default swap agreements that it intends, in each case, to hold for the full term of the agreement. It considers these agreements to be a normal extension of its financial guaranty insurance business, although they are considered derivatives for accounting purposes. These agreements are recorded at fair value. The Company believes that the most meaningful presentation of the financial statement impact of these derivatives is to reflect premiums as installments are received, to record losses and loss adjustment expenses as incurred and to record changes in fair value as incurred. The Company recorded \$35,033,000, \$15,385,000 and \$1,760,000 in net earned premium under these agreements for the years ended December 31, 2002, 2001 and 2000, respectively. The change in fair value, which were losses of \$50.2 million and a gain of \$6.7 million for the years ended December 31, 2002 and 2001, respectively, were recorded in net realized and unrealized gains (losses) on derivative instruments in the consolidated statement of operations and comprehensive income and in other assets or liabilities. The gains and losses recognized by recording these contracts at fair value will be determined each quarter based upon market pricing of Super Triple-A (defined as having first-loss protection of 1.3 times the level required for Triple-A rating) swap guarantees. The Company does not believe the fair value adjustments are an indication of potential claims under the Company's guarantees.

**20. VARIABLE INTEREST ENTITY**

An affiliate of the Company owns 29% of the equity of Global, a Cayman Islands domiciled issuer of FSA-insured notes and other obligations sold in international markets (generally referred to as medium

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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**20. VARIABLE INTEREST ENTITY (Continued)**

term notes or "MTNs"). Global issues securities at the request of interested purchasers in a process known as "reverse inquiry," which generally results in lower interest rates and borrowing costs than would apply to direct borrowings. Global also issues securities in traditional private placements to institutional investors and to participants in lease financings in which the Company and its affiliates may play a number of financing roles. Global is managed as a "matched funding vehicle," in which the proceeds from the sale of Global notes are invested in obligations chosen to provide cash flows substantially matched to those of the Global notes (taking into account, in some cases, dedicated third party liquidity). The matched funding structure minimizes the market risks borne by Global and the Company. Global raises funds in U.S. dollars at LIBOR-based floating borrowing rates and invests its funds in obligations insured by the Company, maturing prior to the maturity of the related Global notes and paying a higher interest rate than the interest rate on the related Global notes. Total assets for Global at December 31, 2002 and 2001 were \$9,182,028,000 (unaudited) and \$3,561,344,000, respectively. Total liabilities at December 31, 2002 and 2001 were \$9,188,967,000 (unaudited) and \$3,565,255,000, respectively. The foregoing assets and liabilities include assets and matched liabilities that are "economically defeased" in lease financings in which the Company and its affiliates may play a number of financing roles. These economically defeased liabilities, and associated assets, are held in separate special purpose entities, Global and Premier International Funding Co. At December 31, 2002 and 2001, Global's economically defeased obligations were \$6,708,688,000 and \$1,982,961,000, respectively. For the years ended December 31, 2002 and 2001, total revenues for Global were \$285,897,000 (unaudited) and \$151,135,000, respectively. For the years ended December 31, 2002 and 2001, total expenses for Global were \$284,945,000 (unaudited) and \$150,530,000, respectively. Global's net income for 2002, 2001 and 2000 was \$952,000 (unaudited), \$605,000 and \$383,000, respectively. Global's net income is determined net of premiums paid by Global to the Company. For the years ended December 31, 2002 and 2001, Global paid premiums to FSA of \$7,707,000 and \$7,502,000, respectively. All amounts insured by the Company relating to Global are included in the Company's outstanding exposure, included in the Notes to the Consolidated Financial Statements for December 31, 2002. As of December 31, 2002, there were no case basis reserves required for any transactions related to Global.

**21. RECENTLY ISSUED ACCOUNTING STANDARDS**

In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46 "Consolidation of Variable Interest Entities" (FIN No. 46), which is an interpretation of Accounting Research Bulletin No. 51, "Consolidated Financial Statements". FIN No. 46 addresses consolidation of VIEs which have one or both of the following characteristics: (1) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity; and (2) the equity investors lack the direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights, the obligation to absorb the expected losses of the entity if they occur or the right to receive the expected residual returns of the entity if they occur. The provisions of FIN No. 46 will be effective immediately for VIEs created after January 31, 2003 and to VIEs in which an enterprise obtains an interest after that date. For VIEs in which an enterprise holds a variable interest that it acquired prior to February 1, 2003, the interpretation is effective in the first fiscal year or interim period beginning after June 15, 2003. Management believes that the implementation of



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**21. RECENTLY ISSUED ACCOUNTING STANDARDS (Continued)**

FIN No. 46, on July 1, 2003, will cause the Company to consolidate for financial reporting purposes, for the first time, Global (see Note 20) and Canadian Global (see Note 8). FIN No. 46 requires that, upon consolidation, the Company shall initially measure the VIEs' assets, liabilities and minority interest at their carrying amounts under existing Accounting Principles Generally Accepted in the United States as if the entity had been consolidated from the time the Company was considered its primary beneficiary (or parent). Any differences upon consolidation on July 1, 2003 will be reflected as a cumulative effect of a change in accounting principle. The carrying amounts of assets, liabilities and minority interest may change significantly from December 31, 2002 to July 1, 2003 as a result of transactions entered into during that period. The Company will continue to analyze the effects of FIN No. 46, considering the timing of its release and the complexity of practical application to the Company's transactions.

In November 2002, the FASB issued FASB Interpretation No. 45 (FIN No. 45), Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an Interpretation of FASB Statements No. 5, 57 and 107 and Rescission of FASB Interpretation No. 34. FIN No. 45 relates to the accounting for and disclosure of guarantees. FIN No. 45 excludes financial guarantee insurance contracts, including those accounted for as insurance contracts and those accounted for as derivatives, from its initial recognition and measurement requirements. However, those contracts accounted for as derivatives are subject to its disclosure requirements. The disclosure requirements in FIN No. 45 are consistent with those already provided by the Company.

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**CONDENSED CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands, except per share data)

	September 30, 2003	December 31, 2002
<b>ASSETS</b>		
Bonds at market value (amortized cost of \$3,186,602 and \$2,597,599) . . . . .	\$3,419,409	\$2,811,747
Guaranteed investment contracts at market value (amortized cost approximates market value) . . . . .	96,400	
Short-term investments . . . . .	161,165	364,565
Total financial guaranty investments . . . . .	3,676,974	3,176,312
Variable interest entities' bonds at market value (amortized costs of \$1,389,953) . . .	1,386,777	
Variable interest entities' guaranteed investment contracts at market value (amortized cost approximates market value) . . . . .	896,875	
Variable interest entities' short-term investments . . . . .	6,723	
Total investments . . . . .	5,967,349	3,176,312
Cash . . . . .	9,435	27,560
Securitized loans at cost . . . . .	449,972	431,718
Deferred acquisition costs . . . . .	258,719	253,777
Prepaid reinsurance premiums . . . . .	668,144	557,659
Reinsurance recoverable on unpaid losses . . . . .	84,963	75,950
Other assets . . . . .	782,252	258,664
<b>TOTAL ASSETS</b> . . . . .	<b>\$8,220,834</b>	<b>\$4,781,640</b>
<b>LIABILITIES AND MINORITY INTEREST AND SHAREHOLDER'S EQUITY</b>		
Deferred premium revenue . . . . .	\$1,766,830	\$1,450,211
Losses and loss adjustment expenses . . . . .	258,751	223,618
Variable interest entities' debt . . . . .	2,634,763	
Deferred federal income taxes . . . . .	170,184	153,333
Notes payable to affiliate . . . . .	448,881	431,360
Notes payable . . . . .	196,572	
Surplus notes . . . . .	152,850	212,850
Accrued expenses and other liabilities . . . . .	383,880	338,943
<b>TOTAL LIABILITIES AND MINORITY INTEREST</b> . . . . .	<b>6,012,711</b>	<b>2,810,315</b>
Preferred stock (5,000.1 and 0 shares authorized; 0 shares issued and outstanding; par value of \$1,000 per share) . . . . .		
Common stock (400 shares authorized, issued and outstanding; par value of \$37,500 per share) . . . . .	15,000	15,000
Additional paid-in capital . . . . .	817,005	813,002
Accumulated other comprehensive income (net of deferred income taxes of \$76,658 and \$70,889) . . . . .	150,461	143,260
Accumulated earnings . . . . .	1,225,657	1,000,063
<b>TOTAL SHAREHOLDER'S EQUITY</b> . . . . .	<b>2,208,123</b>	<b>1,971,325</b>
<b>TOTAL LIABILITIES AND MINORITY INTEREST AND SHAREHOLDER'S EQUITY</b> . . . . .	<b>\$8,220,834</b>	<b>\$4,781,640</b>

See notes to condensed consolidated financial statements.

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
AND COMPREHENSIVE INCOME**

(Dollars in thousands)

	Nine Months Ended September 30,	
	2003	2002
<b>REVENUES:</b>		
Net premiums written . . . . .	\$467,776	\$369,731
Net premiums earned . . . . .	268,469	226,838
Net investment income . . . . .	113,131	101,820
Net realized gains . . . . .	4,740	26,553
Variable interest entities' net interest income . . . . .	7,288	
Net realized and unrealized gains (losses) on derivative instruments . . . . .	9,799	(70,277)
Other income . . . . .	15,797	961
<b>TOTAL REVENUES . . . . .</b>	<b>419,224</b>	<b>285,895</b>
<b>EXPENSES:</b>		
Losses and loss adjustment expenses . . . . .	27,533	50,995
Interest expense . . . . .	22,616	5,693
Variable interest entities' net interest expense . . . . .	5,989	
Policy acquisition costs . . . . .	43,285	39,169
Other operating expenses . . . . .	36,991	30,630
<b>TOTAL EXPENSES . . . . .</b>	<b>136,414</b>	<b>126,487</b>
Minority interest . . . . .	(7,798)	(5,650)
Equity in earnings of unconsolidated affiliate . . . . .	13,558	6,087
<b>INCOME BEFORE INCOME TAXES AND CUMULATIVE EFFECT OF ACCOUNTING CHANGE . . . . .</b>	<b>288,570</b>	<b>159,845</b>
Provision for income taxes . . . . .	(67,776)	(29,823)
<b>INCOME BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGE . . . . .</b>	<b>220,794</b>	<b>130,022</b>
Cumulative effect of accounting change, net of income taxes of \$2,598 . . . . .	4,800	
<b>NET INCOME . . . . .</b>	<b>225,594</b>	<b>130,022</b>
Other comprehensive income, net of tax:		
Unrealized gains on securities:		
Holding gains arising during period . . . . .	10,604	119,883
Less: reclassification adjustment for gains included in net income . . . . .	3,403	19,398
Other comprehensive income . . . . .	7,201	100,485
<b>COMPREHENSIVE INCOME . . . . .</b>	<b>\$232,795</b>	<b>\$230,507</b>

See notes to condensed consolidated financial statements.

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Dollars in thousands)**

	Nine Months Ended September 30,	
	2003	2002
Cash flows from operating activities:		
Premiums received, net	\$ 449,565	\$ 362,080
Policy acquisition and other operating expenses paid, net	(95,328)	(96,764)
Termination fee on derivative		(38,000)
Recoverable advances recovered	73	4,292
Loss and loss adjustment expenses paid, net	(1,273)	(3,820)
Net investment income received	105,221	95,654
Federal income taxes paid	(67,157)	(59,253)
Interest paid	(22,073)	(6,362)
Variable interest entities' interest income received	8,816	
Variable interest entities' interest paid	(6,730)	
Other, net	5,385	(2,027)
Net cash provided by operating activities	<u>(376,499)</u>	<u>255,800</u>
Cash flows from investing activities:		
Proceeds from sales of bonds	690,514	659,205
Purchases of bonds	(1,214,395)	(871,520)
Net decrease (increase) in short-term investments	208,976	(2,414)
Purchases of variable interest entities' bonds	(114,089)	
Net decrease in variable interest entities' short-term investments	12,403	
Purchases of property and equipment	(401)	(5,619)
Other investments, net	(15,493)	6,389
Net cash used for investing activities	<u>(432,485)</u>	<u>(213,959)</u>
Cash flows from financing activities:		
Repayment of surplus notes	(60,000)	(19,000)
Proceeds from issuance of variable interest entities' debt	101,189	
Dividends paid		(8,671)
Capital issuance cost	(3,328)	
Net cash provided by (used for) financing activities	<u>37,861</u>	<u>(27,671)</u>
Net increase (decrease) in cash	(18,125)	14,170
Cash at beginning of period	27,560	5,882
Cash at end of period	<u>\$ 9,435</u>	<u>\$ 20,052</u>

- (a) In the first nine months of 2003 and 2002, the Company received a tax benefit of \$5,684 and \$8,055, respectively, by utilizing its Parent's losses. These amounts were recorded as capital contributions.
- (b) On July 1, 2003, the Company consolidated \$2,891,977 in assets and \$2,893,889 in liabilities relating to variable interest entities with no corresponding cash movement.

See notes to condensed consolidated financial statements.

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
For the Nine Months Ended September 30, 2003 and 2002**

**1. ORGANIZATION AND OWNERSHIP**

Financial Security Assurance Inc. (the Company), a wholly owned subsidiary of Financial Security Assurance Holdings Ltd. (the Parent), is an insurance company domiciled in the State of New York. The Company and its subsidiaries are primarily engaged in the business of providing financial guaranty insurance on asset-backed and municipal obligations. In addition, the Company insures guaranteed investment contracts (GICs) issued by FSA Capital Markets Services LLC and FSA Capital Management Services LLC (collectively, CMS), wholly owned subsidiaries of the Parent.

In the third quarter of 2003, the Company consolidated FSA Global Funding Limited (FSA Global) and Canadian Global Funding Corporation (Canadian Global) as a result of FASB Interpretation No. 46 "Consolidation of Variable Interest Entities" (FIN 46). The Company also consolidated Premier International Funding Co. (Premier) in the third quarter as a result of obtaining control provisions (see Note 9).

**2. BASIS OF PRESENTATION**

The accompanying condensed consolidated financial statements have been prepared by the Company and are unaudited. In the opinion of management, all adjustments, which include only normal recurring adjustments necessary to present fairly the financial position, results of operations and cash flows at September 30, 2003 and for all periods presented, have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These statements should be read in conjunction with the Company's December 31, 2002 consolidated financial statements and notes thereto. The year-end condensed balance sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The results of operations for the periods ended September 30, 2003 and 2002 are not necessarily indicative of the operating results for the full year. Certain prior-year balances have been reclassified to conform to the 2003 presentation.

**3. LOSSES AND LOSS ADJUSTMENT EXPENSES**

The Company establishes a case basis reserve for unpaid losses and loss adjustment expenses for the present value of the estimated loss when, in management's opinion, the likelihood of a future loss on a particular insured obligation is probable and determinable at the balance sheet date. The estimated loss on a transaction is discounted using the then current risk-free rates, which ranged from 4.77% to 6.1%. For insured collateralized debt obligations (CDOs), a case basis reserve is recorded to the extent that the overcollateralization ratio (non-defaulted collateral at par value divided by the debt insured) has fallen below 100% and there is a projected loss when calculating the present value of cash flows.

The Company also maintains a non-specific general reserve, which is available to be applied against future additions or accretions to existing case basis reserves or to new case basis reserves to be established in the future. The general reserve is derived from two calculations. The first is calculated by applying loss factors to the Company's total net par underwritten and discounting the result at the then current risk-free rates. The loss factors used for this purpose have been determined based upon an independent rating agency study of bond defaults and the Company's portfolio characteristics and history. The second pertains to the Company's insured CDOs where a present value "deterministic" approach is utilized to calculate the general reserve for the Company's insured CDOs. The deterministic model applies a run of the collateral portfolio for each transaction considering each CDO transaction's unique attributes (such as reinsurance,

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
For the Nine Months Ended September 30, 2003 and 2002 (Continued)**

**3. LOSSES AND LOSS ADJUSTMENT EXPENSES (Continued)**

individual collateral ratings and status, derivatives purchased, premiums due to the guarantor, etc.) utilizing a Moody's default pattern for frequency of defaults, an estimate of collateral recovery values for severity, and a risk-free rate of interest.

Management of the Company periodically evaluates its estimates for losses and loss adjustment expenses and establishes reserves that management believes are adequate to cover the net present value of the ultimate net cost of claims.

At September 30, 2003, the general reserve totaled \$91.4 million. Net case reserves were \$82.4 million, net of \$85.0 million in reinsurance recoverables.

**4. DERIVATIVE INSTRUMENTS**

The Company has insured a number of credit default swaps that it intends, in each case, to insure for the full term of the swap agreements. It considers these agreements to be a normal extension of its financial guaranty insurance business, although they are considered derivatives for accounting purposes. These agreements are recorded at fair value. The Company believes that the most meaningful presentation of the financial statement impact of these derivatives is to reflect premiums as installments are received, to record losses and loss adjustment expenses as incurred and to record changes in fair value as incurred. The Company recorded \$34.9 million and \$24.7 million in net earned premium under these agreements for the first nine months of 2003 and 2002, respectively. The changes in fair value, which were gains of \$8.6 million and losses of \$33.5 million for the first nine months of 2003 and 2002, respectively, were recorded in net realized and unrealized gains (losses) on derivative instruments in the consolidated statements of operations and comprehensive income and in accrued expenses and other liabilities. The losses or gains recognized by recording these contracts at fair value will be determined each quarter based upon market pricing of Super Triple-A (defined as having first-loss protection of 1.3 times the level required for a Triple-A rating) swap guarantees. The Company does not believe the fair value adjustments are an indication of potential claims under FSA's guarantees. The inception-to-date unrealized loss was recorded in accrued expenses and other liabilities and was \$35.6 million and \$44.2 million at September 30, 2003 and December 31, 2002, respectively.

Derivative instruments, which are primarily designated as fair-value hedges, are entered into to manage the interest rate and currency exchange rate exposure on FSA Global and Canadian Global's debt and investments. The derivatives are recorded at fair value. These derivatives generally include interest rate and foreign currency swap agreements, which are primarily utilized to convert FSA Global and Canadian Global's debt and investments into U.S. dollar floating-rate obligations. The gains and losses relating to these fair-value hedges are included in variable interest entities net interest income and net interest expense, as appropriate, along with the offsetting change in fair value of the hedged item attributable to the risk being hedged, in the consolidated statements of operations and comprehensive income.

**5. SECURITIZED LOANS AND NOTES PAYABLE TO AFFILIATE**

In 2002, the Company exercised certain rights available under its financial guaranty policies and the indentures relating to certain loan-backed notes issued by trusts. Those rights allowed the Company to accelerate the insured notes and pay claims under its insurance policies on an accelerated basis. Refinancing vehicles reimbursed the Company in whole for its claims payment in exchange for an

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
For the Nine Months Ended September 30, 2003 and 2002 (Continued)**

**5. SECURITIZED LOANS AND NOTES PAYABLE TO AFFILIATE (Continued)**

assignment of certain of the Company's rights against the capital of the trusts. The refinancing vehicles secured the funds to purchase the notes by issuing refinanced notes, with interest rates ranging from 1.868% to 6.6389%. These notes were purchased by FSA Asset Management LLC, a wholly owned subsidiary of the Parent. The Company maintains significant reinsurance, first loss and quota share, in respect of these transactions.

Principal payments due under these refinanced notes for the remainder of 2003 and each of the next five years ending December 31 and thereafter, are as follows (in millions):

<u>Year</u>	<u>Principal Amount</u>
2003 .....	\$ 4.0
2004 .....	45.4
2005 .....	46.8
2006 .....	42.0
2007 .....	38.1
2008 .....	36.0
Thereafter .....	236.6
Total .....	<u>\$448.9</u>

**6. VARIABLE INTEREST ENTITIES' DEBT**

As of September 30, 2003, the interest rates on variable interest entities' debt (VIE Debt) were between 1.12% and 7.73% per annum.

Payments due under the VIE Debt (including \$840.0 million of interest accretion on zero coupon obligations) in the remainder of 2003 and each of the next five years ending December 31 and thereafter, are as follows (in millions):

<u>Year</u>	<u>Principal Amount</u>
2003 .....	\$ 0.3
2004 .....	10.3
2005 .....	204.1
2006 .....	87.7
2007 .....	541.8
2008 .....	39.8
Thereafter .....	2,590.8
Total .....	<u>\$3,474.8</u>

**7. OUTSTANDING EXPOSURE**

The Company limits its exposure to losses from writing financial guaranties by underwriting investment-grade obligations, diversifying its portfolio and maintaining rigorous collateral requirements on asset-backed obligations, as well as through reinsurance. The principal amounts of insured obligations in

**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
For the Nine Months Ended September 30, 2003 and 2002 (Continued)**

**7. OUTSTANDING EXPOSURE (Continued)**

the asset-backed insured portfolio are backed by the following types of collateral (in millions) at September 30, 2003 and December 31, 2002:

	<u>Net of Amounts Ceded</u>		<u>Ceded</u>	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
Residential mortgages . . . . .	\$ 20,519	\$ 23,379	\$ 4,233	\$ 5,480
Consumer receivables . . . . .	15,441	19,454	5,534	5,954
Pooled corporate obligations . . . . .	79,295	78,113	12,080	13,007
Investor-owned utility obligations . . . . .	543	619	320	348
Other asset-backed obligations(1) . . . . .	8,283	6,958	3,766	3,225
Total asset-backed obligations . . . . .	<u>\$124,081</u>	<u>\$128,523</u>	<u>\$25,933</u>	<u>\$28,014</u>

(1) Includes \$3,222 million and \$2,430 million, in 2003 and 2002, respectively, in "Net of Amounts Ceded" relating to FSA-insured GICs issued by CMS.

Net of amounts ceded and ceded amounts are not necessarily reflective of the risk retained by FSA since FSA employs first loss reinsurance on a material portion of its asset-backed business.

The principal amount of insured obligations in the municipal insured portfolio includes the following types of issues (in millions) at September 30, 2003 and December 31, 2002:

<u>Types of Issues</u>	<u>Net of Amounts Ceded</u>		<u>Ceded</u>	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
General obligation bonds . . . . .	\$ 64,690	\$ 54,563	\$19,819	\$18,388
Housing revenue bonds . . . . .	7,188	5,833	1,928	1,687
Municipal utility revenue bonds . . . . .	29,166	23,442	14,241	13,468
Health care revenue bonds . . . . .	6,436	5,970	6,767	6,683
Tax-supported bonds (non-general obligation) . . . . .	32,660	27,556	12,802	12,391
Transportation revenue bonds . . . . .	10,694	7,640	7,433	5,748
Other municipal bonds . . . . .	14,386	12,173	6,875	5,761
Total municipal obligations . . . . .	<u>\$165,220</u>	<u>\$137,177</u>	<u>\$69,865</u>	<u>\$64,126</u>

**8. CAPITAL RESOURCES**

In June 2003, \$200.0 million of money market committed preferred trust securities (the CPS Securities) were issued by trusts created for the primary purpose of issuing the CPS Securities, investing the proceeds in high quality commercial paper and providing the Company with a put option for selling to the trust non-cumulative redeemable perpetual preferred stock (the Preferred Stock) of the Company. If a put option were to be exercised by the Company, the applicable trust would use the portion of the proceeds attributable to principal received upon maturity of its assets, net of expenses, and transfer such proceeds to the Company in exchange for Preferred Stock of the Company. The Company pays a floating put premium to the trusts. The cost of the structure was \$3.3 million in the first nine months of 2003 and was recorded in equity. The trusts are vehicles for providing the Company access to new capital at its sole discretion through the exercise of the put option.



**FINANCIAL SECURITY ASSURANCE INC.  
AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
For the Nine Months Ended September 30, 2003 and 2002 (Continued)**

**8. CAPITAL RESOURCES (Continued)**

The Company does not consider itself to be the primary beneficiary of the trusts under FIN 46 because it does not retain the majority of the residual benefits or expected losses.

**9. RECENTLY ISSUED ACCOUNTING STANDARDS**

In January 2003, the FASB issued FIN 46, which is an interpretation of Accounting Research Bulletin No. 51, "Consolidated Financial Statements". FIN 46 addresses consolidation of variable interest entities (VIEs) which have one or both of the following characteristics: (i) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity; and (ii) the equity investors lack the direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights, the obligation to absorb the expected losses of the entity if they occur or the right to receive the expected residual returns of the entity if they occur. In October 2003, the FASB issued FASB Staff Position (FSP) 46-6 that provided a broad deferral of the latest date by which all public entities must apply FIN 46 to certain VIEs, to the first reporting period ending after December 15, 2003. Early application of FIN 46 was encouraged and the deferral did not have to be applied to all VIEs or potential VIEs. The deferral applies to VIEs in which an enterprise holds a variable interest that it acquired prior to February 1, 2003. The provisions of FIN 46 remain effective immediately for VIEs created after January 31, 2003 and for VIEs in which an enterprise obtains an interest after that date.

The Company applied FIN 46 and consolidated for financial reporting purposes, effective July 1, 2003. FSA Global and Canadian Global. In addition, as a result of the Company obtaining control provisions of another VIE, Premier, on July 1, 2003, the Company consolidated Premier beginning July 1, 2003. FIN 46 required that, upon consolidation, the Company initially measure the VIE's assets, liabilities and minority interest at their carrying amounts under existing GAAP as if the entity had been consolidated from the time the Company was considered its primary beneficiary (or parent). The increase in total assets and total liabilities related to the consolidation of these entities was \$2.9 billion. Any differences upon consolidation were reflected as a cumulative effect of a change in accounting principle. The cumulative effect of a change in accounting principle for Canadian Global resulted in additional income of \$4.8 million, net of income tax. There were no cumulative income statement effects from consolidating FSA Global and Premier. FSA Global is managed as a "matched funding vehicle", in which the proceeds from the issuance of FSA guaranteed notes are invested in obligations having cash flows substantially matched to those of, and maturing prior to, such notes. The VIE's permitted activities are limited by charter and do not involve active management. The legal documents that established the VIEs do not permit the sale or other disposal of the transferred financial assets except in automatic response to the terms of such financial assets. The VIEs are structured as bankruptcy remote entities. The Company's management believes that the assets held by the VIEs, including those that are eliminated in consolidation, represent a true sale and the assets held by the VIEs are beyond the reach of the Company and its creditors, even in bankruptcy or other receivership. All intercompany insured amounts between the Company and FSA Global and Canadian Global previously included in the Company's outstanding exposure are excluded from the Notes to the Condensed Consolidated Financial Statements for September 30, 2003.

The Company has identified certain asset-backed transactions that it has insured in the ordinary course of business that may require consolidation under FIN 46. The Company chose not to consolidate

**FINANCIAL SECURITY ASSURANCE INC.  
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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
For the Nine Months Ended September 30, 2003 and 2002 (Continued)**

**9. RECENTLY ISSUED ACCOUNTING STANDARDS (Continued)**

these entities in the third quarter of 2003 as the Company is continuing to assess the impact of FIN 46, in light of the recently issued exposure draft proposing amendments to FIN 46. The Company will continue to analyze the effects of FIN 46, the proposed amendments to FIN 46 and proposed FASB Staff Positions.

Following is a summary of the impact of consolidating FSA Global, Canadian Global and Premier (in thousands) at September 30, 2003:

	Premier/ FSA Global	Canadian Global	Elimination	Total
Bonds . . . . .	\$1,386,777	\$ 35,000	\$	\$1,421,777
GIC assets . . . . .	896,875	96,400		993,275
Short-term investments . . . . .	6,723	4,443		11,166
Other assets . . . . .	392,924	76,897	(1,838)	467,983
Other financial guaranty assets . . . . .			(2,224)	(2,224)
Total Assets . . . . .	<u>\$2,683,299</u>	<u>\$212,740</u>	<u>\$(4,062)</u>	<u>\$2,891,977</u>
Debt . . . . .	\$2,634,763	\$196,752	\$	\$2,831,335
Other liabilities . . . . .	50,448	16,168	(2,224)	64,392
Other financial guaranty liabilities . . . . .			(1,838)	(1,838)
Total Liabilities . . . . .	<u>\$2,685,211</u>	<u>\$212,740</u>	<u>\$(4,062)</u>	<u>\$2,893,889</u>

**10. OTHER ASSETS**

The detailed balances that comprise other assets at September 30, 2003 and December 31, 2002 are as follows (in thousands):

	2003	2002
Other Assets:		
Fair value of VIE swaps . . . . .	\$310,569	\$ —
Tax and loss bonds . . . . .	78,244	67,763
Accrued interest on VIE swaps . . . . .	68,533	—
Accrued interest income . . . . .	43,154	36,447
Other assets . . . . .	281,732	154,454
Total Other Assets . . . . .	<u>\$782,252</u>	<u>\$258,664</u>



Financial Security Assurance Inc.

350 Park Avenue  
New York, NY 10022



Sure-Bid Phone: 212-339-3423  
Sure-Bid Fax: 212-339-3488

To: Financial Advisors/Issuers

**RE: PROCEDURES TO UTILIZE SURE-BID**

The following procedures should be followed to successfully utilize Sure-Bid:

- A) Insert the required language into your bidding documents. (See Appendix A)
- B) Fax or email the Sure-Bid Coordinator (Fax #:212/339-3488)(Email: [surebid@fsa.com](mailto:surebid@fsa.com)), on the **earliest possible date**, the following information:
  - 1. Issuer
  - 2. Name of Issue
  - 3. Par Amount of Issue
  - 4. Sale Date
  - 5. Sale Time
  - 6. Maturity Dates
  - 7. Good Faith Deposit Amount
  - 8. Name of Financial Advisory Firm/Issuer
  - 9. Address of Financial Advisory Firm/Issuer
  - 10. Name of individual advisor and primary contact (the principal contact named will receive the updated notices indication who is bidding using Sure-Bid as well as follow-up calls from Sure-Bid regarding the good faith deposit.)
  - 11. Telephone and facsimile numbers and email for advisor and/or principal contact.
  - 12. Name, address and email where Sure-Bid surety bond should be delivered (typically, this is where the bids will be received the day of the sale.)

This form attached as *Appendix B* may be photocopied and utilized for sending this information. The form is also available on FSA's website and can be completed "on-screen." To access the form, go to [www.fsa.com/surebid](http://www.fsa.com/surebid) and click on "Notice of Sale" in the gray bar at the left side of your screen.

Please advise the Sure-Bid Coordinator immediately of any changes to the information pertaining to your sale.

- C) Send a copy of the preliminary official statement and all bidding documents once they have been prepared to:

***Sure-Bid***

Financial Security Assurance Inc.  
350 Park Ave.  
New York, NY 10022  
Telephone: 888/995-8066(Toll Free),  
Facsimile:212/339-3488,  
Email: [surebid@fsa.com](mailto:surebid@fsa.com)

- D) You will receive a Sure-Bid surety bond via email. The **Attachment I-Authorized Principals List** that you receive will be updated whenever a bidder is added and you will receive these amendments to the Attachment I by facsimile and email.
1. On the day of the sale, Sure-Bid will accept additional bidders up to the time of the sale and will fax or email, to the principal contacts designated, "updates" to the Final list.
  2. Please advise Sure-Bid prior to the sale time if a bidder claiming to be bidding with Sure-Bid does not appear on the list.
- E) If the results of the sale will not be reported over Bloomberg or are incorrectly reported over Bloomberg, please call Sure-Bid and advise us of the name of the winning bidder.
- F) If the successful bidder utilized Sure-Bid, the financial advisor should immediately notify such bidder of the appropriate wire transfer instructions for the good faith deposit.
- G) It is suggested the wiring instructions be written into the Notice of Sale or provided in the *Appendix B* submitted to Sure-Bid. If this is not possible, fax the winning bidder (and Sure-Bid) the wiring instructions for your issue immediately after the winning bidder has been chosen.
- H) Sure-Bid will telephone the principal contact to verify receipt of the good faith deposit the day after the sale.
- I) If the good faith deposit is not wired by the successful bidder and the issuer intends to draw up on the financial surety bonds, Sure-Bid must be advised by the financial advisor/issuer as directed in the "**Notice of Non-Payment**" section of the surety bond.

## APPENDIX A

### (SAMPLE LANGUAGE FOR OFFERING/BID DOCUMENTS)

#### GOOD FAITH DEPOSIT

A Good Faith Deposit ("Deposit") in the form of a certified or cashier's check or a Financial Surety Bond in the amount of \$(\*\*\*\*\*), payable to the order of the (Issuer/Financial Advisor), is required for each bid to be considered. If a check is used, it must accompany each bid. If a Financial Surety Bond is used, it must be from an insurance company licensed to issue such a bond in the State of (Domicile of Issuer), and such bond must be submitted to the Issuer or its Financial Advisor prior to the opening of the bids. The Financial Surety Bond must identify each bidder whose Deposit is guaranteed by such Financial Surety Bond. If the (Bond/Notes/Certificates) are awarded to a bidder utilizing a Financial Surety Bond, then that purchaser ("Purchaser") is required to submit its Deposit to the Issuer or its Financial Advisor in the form of a cashier's check (or wire transfer such amount as instructed by the Issuer or its Financial Advisor) not later than 3:30 PM (Issuer's local time) on the next business day following the award. If such Deposit is not received by that time, the Financial Surety Bond may be drawn by the Issuer to satisfy the Deposit requirement. No interest on the Deposit will accrue to the Purchaser. The Deposit will be applied to the purchase price of the (Bonds/Notes/Certificates). In the event the Purchaser fails to honor its accepted bid, the Deposit will be retained by the Issuer.

**Notice of Sale of Sure-Bid Qualified Issue**

**For use only by financial advisors, issuers or bond counsel. Complete on screen, print and fax to Sure-Bid by 4:00 p.m. Eastern time on the Thursday prior to the week of the sale. Please also fax a copy of the front page and "Good Faith Deposit" Section of the official statement.**

**Appendix B**

**To: Sure-Bid**

Facsimile: 212/339-3488

Email: surebid@fsa.com

Telephone: 212/339-3423

**From: (F.A., Issuer, or Bond Counsel's Full Name and Mailing Address:)**


**Re: Sure-Bid Qualified Issue**

**Issue Information:**

Name of Issuer & State:		
Name of Issue:		
Par Amount of Issue:		Sale Date:
Principal Maturity Dates (years, from - to):		
Good Faith Deposit Amount:		Sale Time
Advisor's Name:	Telephone:	Facsimile:
Principal Contact (if other than advisor):	Telephone:	Facsimile:
Email:		

**Wiring Instructions (Account where good faith deposit should be sent)**

Bank's Name: (please include City and State):	Credit To:
ABA #:	Account #:
For Further Credit To:	
Contact Name & Phone # @ Bank:	

**Send Sure-Bid Surety Bond To (name, email, address, city, state, ZIP):**


Attention:	Telephone:	Facsimile:

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For underwriters bidding on competitive new issues in the municipal bond market, FSA offers an Internet-based service to simplify the process of submitting good faith deposits. Since 1995, in lieu of the traditional cashier's or certified check, FSA has provided Triple-A financial surety bonds.

Through Sure-Bid, we make it easier for underwriters to bid for a municipal issue. This leads to more bids and thus may result in a lower required yield. FSA has issued approximately 22,000 Good Faith Surety Bonds in virtually all fifty states. We currently have a roster of 300 bidders and approximately 2000 financial advisors.

For financial advisors, issuers and bond counsel, the timesaving Sure-Bid program is free of charge. The only requirement is that official documents authorize use of the surety for the good faith deposit.

For underwriters, Sure-Bid saves time and money. Once registered as a subscriber, an underwriter pays a modest premium for the surety bond for each transaction on which it bids. If its bid wins, the underwriter has 24 hours to wire the good faith deposit. Should the underwriter fail to make timely delivery, FSA wires the funds on the same business day. If the bid was not successful, the underwriter has been spared both the withdrawal and redeposit of good faith funds and has earned interest continuously on those funds.

The interactive Sure-Bid Calendar allows anyone to see all the issues currently eligible for Sure-Bid. After logging in, subscribers submit Sure-Bid requests by simply selecting issues on-screen. Requests are also accepted by fax. This enables the bidder to register up until the time of the sale.

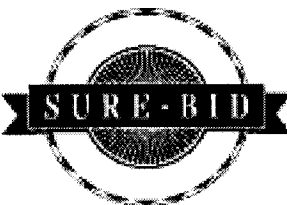
In case of an emergency, we have a contingency plan in place to ensure that all transactions can be processed without interruption. We are committed to providing high quality, responsive service.





**FINANCIAL SECURITY ASSURANCE INC.**

350 Park Avenue New York, NY 10022



Sure-Bid Phone 888/995-8066  
Sure-Bid Fax 212/339-3488  
Sure-Bid Email surebid@fsa.com

February 25, 2004

**John Doe**

Financial Advisor  
11 Advisor Road  
New York, NY 11511

**Phone : (212) 555-1212**

**FAX : (212) 555-1212**

**Email: jdoe@financaladvisor.**

Enclosed please find Good Faith Deposit Financial Surety Bond number 104-0421 ("Financial Surety Bond") issued by Financial Security Assurance Inc. Please review the Financial Surety Bond for accuracy. Should you find any errors, please notify the Sure-Bid Coordinator at 212-339-3423 or by email to surebid@fsa.com immediately.

A list of all bidders ("Authorized Principals") who have requested use of the Financial Surety Bond will be sent via facsimile or email to you prior to the sale.

Attached to the Financial Surety Bond is the Notice of Nonpayment. This form is to be used in the event you must draw on the Financial Surety Bond.

If you have any questions concerning the Financial Surety Bond or the Sure-Bid Program, please do not hesitate to contact me at the Sure-Bid desk by phone at 888-995-8066 or at 212-339-3423 or by email to surebid@fsa.com.

**Financial Security Assurance Inc.**

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**Michelle MacKinnon**  
**Sure-Bid**

**SAMPLE**



**FINANCIAL SECURITY ASSURANCE INC.**  
**GOOD FAITH DEPOSIT FINANCIAL SURETY BOND**

**GOOD FAITH DEPOSIT  
FINANCIAL SURETY BOND**

**Bond No. 104-0421**

**Effective Date:** 02/18/2004

**Expiration Date:** 2/23/2004

**Issuer:** City of Surebid, NY

**Issue:** \$10,000 G.O. Bonds  
Due: 1998 - 1999

**Date of Sale:** 02/18/2004

**Good Faith Deposit Amount :** \$100

**Premium Per Bidder:** \$45.00

FINANCIAL SECURITY ASSURANCE INC. ("Financial Security"), hereby unconditionally and irrevocably guarantees to the above named Issuer, payment, when due and as required pursuant to the offering, and or bid documents for the above named municipal securities ("Issue"), of the "Good Faith Deposit Amount" shown above, by the bidders ("Authorized Principals") approved by FINANCIAL SECURITY prior to the Effective Date.

If the Issuer shall not have received the Good Faith Deposit Amount when due and payable from the successful bidder on the Issue and that successful bidder is an Authorized Principal ("Purchaser"), the Issuer or its Financial Advisor, as directed, may make claim hereunder by delivering (via facsimile followed promptly by overnight courier) to FINANCIAL SECURITY a fully executed Notice of Nonpayment in the form attached hereto. Such Notice of Nonpayment may be submitted on the "Business Day" (a day which is not a Saturday or Sunday and on which FINANCIAL SECURITY is open for business) following the day such Good Faith Deposit was due from Purchaser. FINANCIAL SECURITY shall make payment, via wire transfer, hereunder to the Issuer or its Financial Advisor, as directed, on the Business Day next following receipt of the Notice of Nonpayment.

This Good Faith Deposit Financial Surety Bond is not cancelable by FINANCIAL SECURITY for any reason and shall remain in full force and effect from the Effective Date until the Expiration Date, both as set forth above.

In WITNESS THEREOF, FINANCIAL SECURITY ASSURANCE INC. has caused this Good Faith Deposit Financial Surety Bond to be executed by its duly authorized officers.

**FINANCIAL SECURITY ASSURANCE INC.**

**SAMPLE**

\_\_\_\_\_  
Authorized Officer  
(212)826-0100

[To be typed on letterhead of ISSUER or ISSUER'S FINANCIAL ADVISOR]

## NOTICE OF NONPAYMENT

To: FINANCIAL SECURITY ASSURANCE INC.

350 Park Avenue

Attention: Claims Officer

Telephone: 888/995-8066 Facsimile: 212/339-3488 Email: surebid@fsa.com

Re: Good Faith Deposit Financial Surety Bond Number: .....

Effective Date of Bond: .....

Expiration Date of Bond: .....

Issuer: .....

Name of Issue: .....

Good Faith Deposit Amount: .....

Authorized Principal: .....

Ladies and Gentlemen:

I hereby certify that:

- (1) the Authorized Principal named above is the successful bidder/purchaser of the above captioned Issue;
- (2) such Authorized Principal has failed to make payment of the Good Faith Deposit Amount as required pursuant to the Issue's offering and/or bid documents;
- (3) such payment remains unpaid; and
- (4) this Notice of Nonpayment has been sent to FINANCIAL SECURITY via facsimile, email or other written means prior to the Expiration Date of the Bond.

The issuer hereby requests that FINANCIAL SECURITY make payment of the Good Faith Deposit Amount shown above. Issuer directs that payment under the Good Faith Deposit Financial Surety Bond be made to the following account by bank wire transfer of federal or other immediately available funds:

.....  
[Bank Account and Wire Transfer Instructions]

If Issuer or its Financial Advisor subsequently receives such Good Faith Deposit from the Authorized Principal Issuer or its Financial Advisor hereby agrees to immediately return to FINANCIAL SECURITY all monies paid by FINANCIAL SECURITY pursuant to the Good Deposit Financial Surety Bond.

I hereby certify that I am duly authorized by Issuer to execute and deliver this Notice of Nonpayment.

Date: .....

Issuer or its Financial Advisor: .....

(Type Issuer or Financial Advisory Firm name)

(Print Name)

(Title)

(Signature)

**SAMPLE**